

No. 16496 ✓

United States
Court of Appeals
for the Ninth Circuit

WILBUR SECURITY COMPANY,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of Record

Petition to Review a Decision of The Tax Court
of the United States

FILED

OCT 12 1959

PAUL P. O'BRIEN, CLERK

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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NAMES AND ADDRESSES OF ATTORNEYS

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Washington 25, D. C.,

Attorney for Respondent.



Tax Court of the United States

Docket No. 68408

WILBUR SECURITY COMPANY,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION

1. The Petitioner is a duly authorized Washington corporation with its principal office being located in the City of Wilbur, State of Washington. The returns for the periods here involved were filed with the District Director of Internal Revenue at Tacoma, Washington.

2. The statutory notice of deficiency (a copy of which is attached hereto and marked Exhibit "A"), was mailed to the Petitioner on June 7, 1957.

3. The deficiency in tax as asserted by the Commissioner is in income taxes for the calendar years 1953, 1954, and 1955, in the aggregate amount of \$48,465.61, of which the entire amount is in dispute.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in disallowing the following amounts as interest deductions to the Petitioner for each of the following taxable years:

Year	Interest Deductions Denied
1953.....	\$32,311.10
1954.....	\$33,151.10
1955.....	\$33,151.10

(b) The Commissioner of Internal Revenue erred by increasing Petitioner's income for the taxable year 1953 in the amount of \$840.

5. The facts upon which the Petitioner (hereinafter referred to as the Petitioner or as the corporation) relies on as a basis of this proceeding are as follows:

(a) Petitioner was organized in March of 1915, with an authorized capital of \$25,000, which was divided into 250 shares of the par value of \$100 a share.

(b) Subsequent to its organization, the Petitioner from time to time borrowed sums of money from its stockholders and other individuals. During the taxable years, 1953, 1954, and 1955, the amount of such loans, from stockholders, and other individuals who owned no stock in Petitioner, was approximately \$552,518.40. The loans made by the stockholders to the Petitioner in the years involved herein were not made in proportion to their stock ownership. A portion of the above indebtedness was owed to individuals who owned no stock in Petitioner.

(c) During the taxable years 1953, 1954, and 1955, the working capital available to Petitioner far exceeded the amount of the loans outstanding; the

value of Petitioner's assets, plus surplus, far exceeded the amount of loans outstanding.

(d) During the taxable years 1953, 1954, and 1955, the Petitioner paid the following amounts of interest on the outstanding loans as was provided for in the notes issued to the creditors of the Petitioner:

Year	Interest Paid
1953.....	\$32,311.10
1954.....	\$33,151.10
1955.....	\$33,151.10

(e) Some of the interest paid by the Petitioner on the corporate indebtedness, which was evidenced by notes issued by Petitioner to the creditors, was paid during the taxable years 1953, 1954, and 1955, to individuals who owned stock in Petitioner and some of the interest so paid was to individuals who possessed no stock ownership in Petitioner. The payments of interest made to persons possessing a stock ownership in the Petitioner were not made pro-rata in accordance with the stock ownership.

(f) It was never the intention of any creditor of Petitioner that the loans made to Petitioner should be subordinate to other creditors and accordingly the loans were never subordinated to other indebtedness. The loans to Petitioner were not intended to be at the risk of the business and were at all times intended as amounts that would be paid by Petitioner on demand or at the time provided for in the notes which evidenced the indebtedness.

(g) During each of the taxable years, 1953, 1954, and 1955, Petitioner paid a dividend to its stockholders.

(h) Petitioner deducted the interest payments made in the taxable years 1953, 1954, and 1955, from its income in arriving at its taxable income for said years and said deductions should not have been disturbed by the Commissioner of Internal Revenue, since the interest payments were made on bona fide loans and properly deductible.

(i) During the taxable year 1953, one of Petitioner's noteholders received a repayment of \$14,000. This amount was later re-loaned to Petitioner. Petitioner received no payment of interest in the amount of \$840.

Wherefore it is prayed that this court hear the proceeding and find that Petitioner herein properly reported its income for each of the taxable years, 1953, 1954, and 1955, and that the Commissioner of Internal Revenue has erroneously asserted Petitioner had a deficiency in its income tax for the taxable years, 1953, 1954, and 1955.

/s/ PAUL CASTOLDI.

/s/ FRANCIS J. BUTLER.

Duly Verified.

Form 1231 (App.)

123 U. S. Court House

Seattle 4, Washington

June 7, 1957

Ap:S:AA:90D

JAF:JHR

Wilbur Security Company

Wilbur

Washington

Gentlemen:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1953, December 31, 1954 and December 31, 1955 disclosed deficiencies in tax aggregating \$48,465.61 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward

it to the Assistant Regional Commissioner, Appellate, 123 U. S. Court House, Seattle 4, Washington. The signing and filing of this form will expedite the closing of your case by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is the earlier.

Very truly yours,

RUSSELL C. HARRINGTON,
Commissioner,

By /s/ JAMES E. WESTIN,
Associate Chief, Appellate Division.

Enclosures:

Statement

Agreement Form

IRS Pub. No. 160

JAF:JHR:hme

Ap:S:AA:90D

JAF:JHR

STATEMENT

Wilbur Security Company
Wilbur, Washington

Tax liability for the taxable years ended December 31, 1953,
December 31, 1954 and December 31, 1955.

Income Tax

Year	Liability	Assessed	Deficiency
1953	\$ 41,259.35	\$27,302.09	\$13,957.26
1954	46,142.74	28,888.57	17,254.17
1955	41,206.81	23,952.63	17,254.18
Total	<u>\$128,608.90</u>	<u>\$80,143.29</u>	<u>\$48,465.61</u>

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated October 8, 1956; to your protest dated March 12, 1957 and to the statements made at the conference held on April 24, 1957.

A copy of this letter and statement has been mailed to your representative, Mr. Paul Castoldi, 811 Paulsen Building, Spokane, Washington, in accordance with the authority contained in the power of attorney executed by you.

Taxable Year Ended December 31, 1953

Adjustments to Net Income

	Income Tax	Excess Profits Tax
Net income disclosed by return, Form No. 1120	\$57,889.47	\$79,842.80
Unallowable deductions and additional income:		
(a) Interest income	840.00	840.00
(b) Interest expense	32,311.10	8,077.77
(c) Depreciation	30.00	30.00
Net income as adjusted	<u>\$91,070.57</u>	<u>\$88,790.57</u>

Explanation of Adjustments

(a) On your 1953 return the amount of \$840.00 representing interest at 6% on a \$14,000.00 loan to the Estate of Sarah Farnsworth was not included in taxable income, but was applied as an offset against purported interest expense. Taxable income reported has been increased to include this unreported interest income.

(b) The amount of \$32,311.10 claimed on your return as a deduction for interest expense is disallowed on the ground that it did not constitute interest on indebtedness. In view of the foregoing, excess profits net income is increased in the amount of \$8,077.77 to reflect the elimination of the adjustment for interest on borrowed capital.

(c) On January 1, 1953 you acquired the Wilbur Garage Building, together with land, at a total cost of \$24,477.91. Based upon known values of adjacent and similar property it is held that \$1,000.00 of such cost should be allocated to the land and that the remainder or \$23,477.91 correctly reflects the basis of the

building on which depreciation is allowable at the rate of 3% as claimed on your return. Accordingly, allowable depreciation is reduced in the amount of \$30.00 in each of the years 1953, 1954 and 1955 to reflect the elimination of depreciation claimed on the land.

Computation of Tax

Net income adjusted	\$ 91,070.57
Less: Dividends received credit (85% of \$25.00)	21.25
<hr/>	
Surtax net income	\$ 91,049.32
Less: Excess of net long term capital gain over net short term capital loss	2,255.00
<hr/>	
Surtax net income for purpose of alternative tax	\$ 88,794.32
<hr/>	
Combined normal tax and surtax on \$88,794.32 at 52% minus \$5,500.00	\$ 40,673.05
Plus: 26% of net long term capital gain	586.30
<hr/>	
Income tax liability	\$ 41,259.35
Excess profits tax	None
<hr/>	
Total income and excess profits tax	\$ 41,259.35
Assessed: Original Account No. OF-200032	27,302.09
<hr/>	
Deficiency	\$ 13,957.26
<hr/>	

Excess Profits Credit—Based on Invested Capital

1. Equity (invested) capital at beginning of year asset method	\$752,756.65
2. Average addition for taxable year	<hr/>
3. 75% of average borrowed capital for year	<hr/>
4. Recent loss adjustment (Asset Method only)	<hr/>
5. Total (Lines 1-4)	752,756.65
<hr/>	
6. Average reduction for taxable year	<hr/>
7. Balance (Line 5 minus Line 6)	752,756.65
<hr/>	
8. Net new capital addition (where applicable— Asset Method Only)	<hr/>
9. Invested capital (Line 7 minus Line 8)	\$752,756.65
<hr/>	

10. Portion of Invested Capital and Applicable Credit	
Portion (\$752,756.65) not over 5,000,000 at 12%	90,330.80
Portion (\$.....) over 5,000,000 but not over 10,000,000 at 10%	
Portion (\$.....) over 10,000,000 at 8%	
11. Invested Capital Credit (Total of Line 10)	90,330.80
12. Total inadmissible assets	\$ 500.00
13. Total Assets	\$748,908.34
14. Percentage which Line 12 is of Line 13	.0667638%
15. Reduction for inadmissible assets (Line 11 multiplied by line 14)	60.31
16. Line 11 minus Line 15	\$ 90,270.49
17. New capital credit (12% of line amount on line 8)	
18. Excess Profits Credit—Based on Invested Capital (Line 16 plus Line 17)	\$ 90,270.49
Excess Profits Tax	
Excess profits net income as corrected	\$ 88,790.57
Excess profits credit	90,270.49
Adjusted excess profits net income	None
Excess profits tax	None

Taxable Year Ended December 31, 1954

Adjustments to Net Income

Net income disclosed by return, Form No. 1120	\$ 68,881.86
Unallowable deductions and additional income:	
(a) Interest expense	33,151.10
(b) Depreciation	30.00
Net income adjusted	\$102,062.96

Explanation of Adjustments

(a) The amount of \$33,151.10 claimed on your return as a deduction for interest expense is disallowed on the ground that it did not constitute interest on indebtedness.

(b) For explanation of adjustment see Item (c) above.

Computation of Tax

Net income adjusted	\$102,062.96
Less: Net long term capital gain	5,500.00
	<hr/>
Balance subject to tax	\$ 96,562.96
	<hr/>
Partial tax (52% of 96,562.96 minus \$5,500.00)	44,712.74
Plus: 26% of net long term capital gain	1,430.00
	<hr/>
Income tax liability	\$ 46,142.74
Assessed: Original Account No. CF-200121	28,888.57
	<hr/>
Deficiency of income tax	\$ 17,254.17
	<hr/>

Taxable Year Ended December 31, 1955

Adjustments to Net Income

Net income disclosed by return, Form No. 1120	\$ 56,639.68
Unallowable deductions and additional income:	
(a) Interest expense	33,151.10
(b) Depreciation	30.00
	<hr/>
Net income adjusted	\$ 89,820.78

Explanation of Adjustments

(a) The amount of \$33,151.10 claimed on your return as a deduction for interest expense is disallowed on the ground that it did not constitute interest on indebtedness.

(b) For explanation of adjustment see Item (c) above.

Computation of Tax

Net income adjusted	\$ 89,820.78
	<hr/>
Income tax liability (52% of \$89,820.78 minus \$5,500.00)	41,206.81
Assessed: Original Account No. CI-200166	23,952.63
	<hr/>
Deficiency of income tax	\$ 17,254.18
	<hr/>

Served and Entered June 27, 1957.

[Endorsed]: T.C.U.S. Filed June 24, 1957.

[Title of Tax Court and Cause.]

ANSWER

The Respondent, in answer to the petition filed in the above-entitled case, admits and denies as follows:

1. Admits the allegations of paragraph 1 of the petition.

2. Admits the allegations of paragraph 2 of the petition.

3. Admits the allegations of paragraph 3 of the petition.

4. (a) and (b) Denies that the respondent erred in his determination of deficiencies in income tax as set forth in the notice of deficiency from which the petitioner's appeal is taken. Specifically denies that he erred in the manner and form as alleged in paragraph 4 (a) and (b) of the petition.

5. (a) Admits that petitioner was organized in March, 1915. Denies the remaining allegations of paragraph 5 (a) of the petition.

(b) and (c). Denies the allegations of paragraph 5 (b) and (c) of the petition.

(d). Admits that petitioner paid the amounts of \$32,311.10, \$33,151.10 and \$33,151.10 during the respective taxable years of 1953, 1954 and 1955. Denies the remaining allegations of paragraph 5 (d) of the petition.

(e) and (f). Denies the allegations of paragraph 5 (e) and (f) of the petition.

(g). Admits the allegations of paragraph 5 (g) of the petition.

(h). Admits that petitioner claimed deductions

for interest payments in the taxable years 1953, 1954 and 1955, in reporting its taxable income for those years. Denies the remaining allegations of paragraph 5(h) of the petition.

(i). Denies the allegations of paragraph 5 (i) of the petition.

6. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the deficiencies determined by the respondent be in all respects approved.

/s/ NELSON P. ROSE, (W.H.P.)

Chief Counsel, Internal Revenue
Service.

Of Counsel: Melvin L. Sears, Regional Counsel,
Wilford H. Payne, Assistant Regional Counsel,
John H. Welch, Attorney, Internal Revenue
Service, 211 U. S. Court House, Seattle 4,
Washington.

Served and Entered August 6, 1957.

[Endorsed]: T.C.U.S. Filed July 31, 1957.

[Title of Tax Court and Cause.]

STIPULATION OF FACTS

It is hereby stipulated that, for the purpose of this case, the following statements may be accepted as facts and all exhibits referred to herein and at-

tached hereto are incorporated in this stipulation and made a part thereof, subject to the right of either party to object to the admission of such facts and exhibits in evidence on the grounds of materiality or relevancy; provided, however, that either party may introduce other and further evidence not inconsistent with the facts herein stipulated.

1. The Wilbur Security Company (hereinafter referred to as the Petitioner or the Corporation) is a duly authorized Washington corporation with its principal office being located in the City of Wilbur, State of Washington. The following were the subscribers to the original stock of the corporation:

Name	Stock	Amount Subscribed For
E. L. Farnsworth	120 Shares	\$12,000.00
J. McPherson	105 Shares	10,500.00
Charles Hudkins	10 Shares	1,000.00
G. Thompson	10 Shares	1,000.00
E. H. Oswalt	5 Shares	500.00
<hr/>		
Total	250 Shares	\$25,000.00

2. There is attached hereto marked Exhibit 1-A and made a part of this stipulation by reference, the United States Corporate income tax return and attached schedules filed by the corporation for the taxable year 1953 with the District Director of Internal Revenue at Tacoma, Washington.

3. There is attached hereto marked Exhibit 2-B and made a part of this stipulation of facts by reference, a consent signed by the Commissioner of Internal Revenue and the corporation extending the period of limitation upon assessment for the taxable year 1953 to June 30, 1958.

4. There is attached hereto marked Exhibit 3-C and made a part hereof by this reference, the United States Corporate income tax return filed by Wilbur Security Company for the taxable year 1954 with the District Director of Internal Revenue at Tacoma, Washington.

5. There is attached hereto marked Exhibit 4-D and made a part of this stipulation by this reference, the United States Corporation income tax return filed by the Wilbur Security Company for the taxable year 1955 with the District Director of Internal Revenue in Tacoma, Washington.

6. The Corporation was organized on the 18th day of March, 1915. There is attached hereto marked Exhibit 5-E and made a part of this stipulation by this reference, a copy of the minutes of the first meeting of the Corporation together with the original articles of incorporation.

7. On the 5th day of April, 1915, the stockholders of the Petitioner held a meeting. There is attached hereto marked Exhibit 6-F and made a part hereof by this reference, a copy of the minutes of said meeting. The provision contained in Amendment 1, Article XII of the By-Laws has never been amended in the minutes of the Corporation.

8. There is attached hereto, marked as Exhibit 7-G and made a part of this stipulation by reference, a copy of the minutes of a special meeting of the trustees of Wilbur Security Company held on the 28th day of December, 1916. Pursuant to the action taken at the said meeting, the sum of

\$25,000 was set up in the books of the Corporation as paid-in capital.

9. There is attached hereto and marked Exhibit 8-H, a computation which shows the amounts in the stockholder accounts during each of the years 1915 until 1938. This amount of \$200,000 was from 1915 until 1938 carried in the corporate books under the heading of "Special Stockholders Account."

10. In addition to the \$200,000 referred to in Exhibit 8-H above, the Corporation obtained money from other sources. There is attached hereto marked Exhibit 9-I and made a part of this stipulation by this reference, a computation which shows the amounts so obtained in each of the years 1915 to 1938 and the source from which it was obtained. These amounts were carried on the books of the Corporation during these years under the heading of "Special Account."

11. Grace Phillips, referred to in Exhibit 9-I was the daughter of E. L. Farnsworth. Kate and Julie McPherson are the sisters of J. McPherson. Neither Grace Phillips, Kate or Julie McPherson owned any stock in the Corporation during any of the years 1915 to 1938. D. K. McPherson is the father of J. McPherson.

12. At a special meeting of the Wilbur Security Company held in the office of the Wilbur Security Company, June 5, 1939, it was unanimously adopted and carried that the "Stockholders Account" on the books of the Wilbur Security Company which totaled \$200,000 should be paid off and distributed to the owners thereof. There is attached hereto marked

Exhibit 10-J and made a part of this stipulation by reference, a copy of the original minutes of said meeting. There is also attached hereto and marked Exhibit 11-K and made a part of this stipulation by this reference, a copy of the direction to the Wilbur Security Company to pay over the \$200,000 referred to in the minutes of the meeting held June 5, 1939, signed by the then owners of the stockholders' account.

13. The books of the corporation under the above said date show the above change referred to in paragraph 12, above, as follows:

As of the 5th day of June, 1939, the amounts outstanding in the stockholders' accounts were paid by cash, per books, to the individuals having balances in the said accounts. On the same date the books show that the same amounts were re-deposited in the "Special Account" to the credit of the same individuals.

No cash actually changed hands and no checks were drawn but book entries were made indicating a payment of the stockholders' account.

As of this date the special account balances on the books of the Corporation equalled the total balances shown on Exhibits 8-H and 9-I.

There is attached hereto and marked Exhibit 12-L a schedule showing the outstanding balances in the Special Account from 1939 to 1942.

14. Attached hereto marked Exhibit 13-M and made a part of this stipulation by reference, is a copy of the minutes of directors or trustees of Wil-

bur Security Company held on the 19th day of January, 1943, and on the 20th day of January, 1943.

There is attached hereto marked Exhibit 14-N and made a part of this stipulation by reference, the entries made in the books of the Corporation pursuant to the action of the board of trustees referred to in Exhibit 13-M above. The entries contained in Exhibit 14-N represent all of the said entries on the bills payable account from the above date until December 31, 1955.

15. There is attached hereto marked Exhibit 15-O and made a part of this stipulation by reference, the minutes of the meeting of the board of trustees of the Wilbur Security Company, held January 13, 1953.

16. There is attached hereto marked Exhibit 15-O(a) and made a part of this stipulation by reference, the minutes of the meeting of the Board of Directors of the Wilbur Security Company dated December 1, 1953.

17. There is attached hereto marked Exhibit 16-P and made a part of this stipulation by reference, the minutes of the meeting of the trustees of the Wilbur Security Company held on the 12th day of January, 1954.

18. There is attached hereto marked Exhibit 17-Q and made a part of this stipulation by reference, the minutes of a meeting of the trustees of the Wilbur Security Company held on the 11th day of January, 1955.

19. There is attached hereto and marked Exhibit

18-R and made a part of this stipulation by this reference, a schedule which shows the stock ownership in the corporation at the end of each year from 1915 until 1955, in terms of stock certificates issued.

The ninety shares of stock shown as acquired by Grace Phillips in the year 1955 were acquired by a stock certificate issued on or about August 17, 1955.

20. There is attached hereto marked Exhibit 19-S and made a part of this stipulation by reference a schedule showing the amounts outstanding in the Bills Payable account in each of the years 1943 to 1955, inclusive.

The \$63,829.80 amount added to the total shown in 1955 of Grace Phillips was transferred per the books of the Corporation as of December 31, 1955.

21. During the taxable years 1953, 1954, and 1955, the stock of record of the Wilbur Security Company was held in the following amounts and in the following percentages:

Stockholder	No. 1953		No. 1954		No. 1955	
	Shares	%	Shares	%	Shares	%
Grace Phillips					90	36%
Sarah Farnsworth	90	36%	90	36%		
Elizabeth McPherson	5	2%	5	2%	5	2%
J. McPherson	102½	41%	102½	41%	102½	41%
J. K. McPherson	25	10%	25	10%	25	10%
E. H. Oswalt	7½	3%	7½	3%	7½	3%
G. Thompson	20	8%	20	8%	20	8%
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
	250	100%	250	100%	250	100%

22. During the taxable years 1953, 1954, and 1955, the following individuals had the following amounts outstanding in the Bills Payable account in the following percentages:

Name	Amount 1953 %		Amount 1954 %		Amount 1955 %	
h Farnsworth	\$ 63,829.80	11.55%	\$ 63,829.80	11.55%	\$	
e Phillips	83,298.60	15.08%	83,298.60	15.08%	147,128.40	26.62%
erine Bernhard	25,000.00	4.52%	25,000.00	4.52%	25,000.00	4.52%
beth McPherson	4,000.00	.72%	4,000.00	.75%	4,000.00	.72%
McPherson	144,000.00	26.06%	144,000.00	26.06%	144,000.00	26.06%
c McPherson	24,000.00	4.34%	24,000.00	4.34%	24,000.00	4.34%
McPherson	99,390.00	17.99%	99,390.00	17.99%	99,390.00	17.99%
McPherson	87,000.00	15.75%	87,000.00	15.75%	87,000.00	15.75%
. Oswalt	6,000.00	1.09%	6,000.00	1.09%	6,000.00	1.09%
hompson	16,000.00	2.90%	16,000.00	2.90%	16,000.00	2.90%
\$552,518.40		100.00%	\$552,518.40		100.00%	\$552,518.40 100.00%

Elizabeth McPherson is the wife of J. McPherson and the mother of J. K. McPherson. Catherine Bernhard is the married daughter of J. McPherson and Elizabeth McPherson and the sister of J. K. McPherson.

23. There is attached hereto and marked Exhibit 20-T and made a part of this stipulation by reference a schedule showing the surplus of the corporation available at the end of each of the years 1915 to 1955, inclusive.

24. There is attached hereto marked Exhibit 21-U and made a part of this stipulation of facts by reference, a schedule showing the dividends paid by the corporation during each of the taxable years 1915 to 1955, inclusive, exclusive of amounts paid and deducted as interest which are in issue.

25. There is attached hereto marked Exhibit 22-V and by this reference made a part of this stipulation of facts, a schedule showing the salaries paid by the corporation during each of the years 1915 to 1955, inclusive. These salaries were paid to

officers of the corporation. No other salaries or wages were paid.

27. There is attached hereto marked Exhibit 24-X and made a part of this stipulation by reference, a balance sheet of the Corporation as of December 31, 1953, as shown by its books.

28. There is attached hereto marked Exhibit 25-Y and made a part of this stipulation by reference, a balance sheet of the Corporation as of December 31, 1954, as shown by its books.

29. There is attached hereto marked Exhibit 26-Z and made a part of this stipulation by reference, a balance sheet of the Corporation as of December 31, 1955, as shown by its books.

30. There is attached hereto marked Exhibit 27-AA and made a part of this stipulation of facts by reference, the description of the farms owned by the Corporation, said farms having been owned by the Corporation from the date of acquisition until the present time and were being held during each of the taxable years 1953, 1954 and 1955.

31. There is attached hereto marked Exhibit 28-BB and by this reference made a part of this stipulation of facts, a letter dated December 11, 1956, addressed to J. K. McPherson, President, State Bank of Wilbur, Wilbur, Washington, signed by R. J. Stole, Vice-President, The National Bank of Commerce of Seattle, located 2nd Avenue at Spring Street in Seattle, Washington.

32. There is attached hereto marked Exhibit 29-CC and made a part of this stipulation by reference, the notes executed by the Wilbur Security

Company on March 10, 1943, on the amounts then outstanding in the Bills Payable Account.

33. There is attached hereto marked Exhibit 30-DD and made a part of this stipulation by reference, the notes executed by the Wilbur Security Company on December 31, 1943, on the amounts then outstanding in the Bills Payable Account.

34. There is attached hereto marked Exhibit 31-EE and made a part of this stipulation by reference, the notes executed by the Wilbur Security Company on December 30, 1944, on the amounts then outstanding in the Bills Payable Account.

35. There is attached hereto marked Exhibit 32-FF and made a part of this stipulation by reference, the notes executed by the Wilbur Security Company on December 31, 1945, on the amounts then outstanding in the Bills Payable Account.

36. There is attached hereto marked Exhibit 33-GG and made a part of this stipulation by reference, the notes executed by the Wilbur Security Company on December 31, 1946, on the amounts then outstanding in the Bills Payable Account.

37. There is attached hereto marked Exhibit 34-HH and made a part of this stipulation by reference, the notes executed by the Wilbur Security Company on December 31, 1947, on the amounts then outstanding in the Bills Payable Account.

38. There is attached hereto marked Exhibit 35-II and made a part of this stipulation by reference, the notes executed by the Wilbur Security Company on December 31, 1951, on the amounts then outstanding in the Bills Payable Account.

39. There is attached hereto marked Exhibit 36-JJ and made a part of this stipulation by reference, the notes executed by the Wilbur Security Company on December 31, 1955, on the amounts then outstanding in the Bills Payable Account.

40. The Internal Revenue Service investigated the income tax returns filed by the Corporation herein for the taxable years 1937 and 1938. The Corporation by and through counsel protested the adjustments asserted by the Revenue Service for said taxable years 1937 and 1938.

41. There is attached hereto marked Exhibit 37-KK and made a part of this stipulation by reference, a letter dated August 2, 1939 sent by the Internal Revenue Service to the Petitioner herein.

42. There is attached hereto marked Exhibit 38-LL and made a part of this stipulation by reference, a letter to the Corporation from the Internal Revenue Service dated October 2, 1939.

43. There is attached hereto marked Exhibit 39-MM and made a part of this stipulation by reference, a letter dated October 26, 1939, from the Acting Internal Revenue Agent in Charge, to the Corporation.

44. There is attached hereto marked Exhibit 40-NN and made a part of this stipulation by reference, a copy of the Protest filed by the Corporation protesting the asserted deficiency in income tax for the year 1937.

45. During both the Excess Profits Tax periods (i.e., World War II and the Korean War), the Corporation treated the amounts outstanding as set

forth in Exhibits 12-L and 19-S as borrowed capital in computing the excess profits tax credit.

46. There is attached hereto marked Exhibit 41-OO and made a part of this stipulation by reference, the minutes of the meeting of the Board of Trustees of the Wilbur Security Company dated January 8, 1952.

47. There is attached hereto marked Exhibit 42-PP and made a part of this stipulation by reference, the minutes of the meeting of the Board of Trustees of the Wilbur Security Company dated November 4, 1952.

48. There is attached hereto marked Exhibit 43-QQ, the original By-Laws of the Corporation.

/s/ PAUL CASTOLDI,

/s/ FRANCIS J. BUTLER,

Counsel for Petitioner.

/s/ ARCH M. CANTRALL, (W.H.P.)

Chief Counsel, Internal Revenue Service, Counsel
for Respondent.

[Endorsed]: T.C.U.S. Filed March 17, 1958.

[Title of Tax Court and Cause.]

SUPPLEMENTAL STIPULATION OF FACTS

This case was tried before the Tax Court in Seattle, Washington on March 17, 1958 and the record was held open until April 16, 1958 to receive a supplemental Stipulation of Facts. Accordingly it is stipulated that the following statements may be

accepted as facts and the attached exhibits made a part of the record in this case.

49. There is attached hereto, marked Ex. 45-RR the minutes of a meeting of the Board of Trustees of Wilbur Security Company dated December 30, 1940.

50. There is attached hereto marked Ex. 46-SS the minutes of a meeting of the Board of Trustees of Wilbur Security Company dated December 30, 1941.

51. There is attached hereto, marked Ex. 47-TT the minutes of a meeting of the Board of Trustees of Wilbur Security Company dated December 31, 1942.

/s/ PAUL CASTOLDI,

Counsel for Petitioner.

/s/ ARCH M. CANTRALL, (W.H.P.)

Chief Counsel, Internal Revenue Service, Counsel
for Respondent.

[Endorsed]: T.C.U.S. Filed April 16, 1958.

31 T. C. No. 92

Tax Court of the United States

Wilbur Security Company, Petitioner, v. Commissioner of Internal Revenue, Respondent.

Docket No. 68408. Filed January 30, 1959

FINDINGS OF FACT AND OPINION

Petitioner's yearly payments, which it designated as interest, on its Bills Payable Account, held, on

the facts of this case, to constitute dividends and not deductible interest.

Held, further, petitioner realized \$840 interest income from an advance it had made to one of its stockholders.

Francis J. Butler, Esq., and Paul Castoldi, Esq., for the petitioner.

George E. Constable, Esq., for the respondent.

Train, Judge: Respondent determined deficiencies in petitioner's income taxes as follows:

Year	Deficiency
1953	\$13,957.26
1954	17,254.17
1955	17,254.18

The issues are (1) whether the amounts outstanding in petitioner's Bills Payable Account, upon which disbursements as interest expense were made during the years involved, constitute bona fide indebtedness of the corporation or whether, in reality, such amounts constitute equity capital invested in petitioner's business; and (2) whether petitioner failed to report interest income in the amount of \$840 on its income and excess profits tax return for 1953.

Findings of Fact

Some of the facts have been stipulated and are hereby found as stipulated.

Petitioner, the Wilbur Security Company, hereinafter referred to as the Company, is a Washington corporation with its principal office located in the city of Wilbur, Washington. Its corporation

income and excess profits tax return for the calendar year 1953 and its corporation income tax returns for the calendar years 1954 and 1955 were timely filed with the district director of internal revenue at Tacoma, Washington.

In 1915, the city of Wilbur, Washington, a small community of less than 1,100 population, was serviced by a single bank, the Wilbur State Bank, hereinafter referred to as the Bank. The stockholders of the Bank had a large amount of money on deposit with the Bank. The stockholders considered that the existence of such large deposits might attract other banking concerns to the city of Wilbur. To forestall such competition from developing, the stockholders of the Bank formed the Company on March 18, 1915. A further purpose of the formation of the Company was to provide an entity which would serve and hold such of the Bank's customers as required long-term loans that the Bank, under existing restrictions, could not carry.

As originally constituted, the Company's Articles of Incorporation provided in part as follows:

Article Two

The objects for which this corporation are formed are:

* * * * *

3. To charge and collect interest upon money loaned, invested or otherwise handled by it, and to derive profit upon any and all transactions by it, and to collect any share of any profit, result or

property involved in any contract or transaction relating to its business.

* * * * *

5. In all ways in its own right, to purchase, acquire, manage, develop, operate, improve, change, exchange, mortgage, lease, pledge, hypothecate, sell and dispose or [sic] properties and interests of all kinds, whether real, personal or mixed and where-soever situate.

6. To take, acquire, purchase, own, sell, lease, exchange, pledge, mortgage, hypothecate, grant, improve and otherwise deal in real estate, townsites and divisions, lots or subdivisions thereof, and to issue evidences of interest, title, or right in any such property, either in its own right or its rights under contract.

* * * * *

9. To borrow or raise money upon all bonds, warrants, debentures, investment certificates and other negotiable or transferable instruments, or otherwise, as directed by the board of trustees.

10. To lend money or other property on its own account and to receive notes, obligations and evidences therefor, and conveyances, hypothecations and pledges as security for its repayment or redelivery of the same.

* * * * *

Article Three

The capital stock of this corporation shall be Twenty-five thousand (\$25,000.00) Dollars, divided

into Two Hundred Fifty (250) shares of the par value of One hundred (\$100.00) dollars per share.

* * * * *

Article Six

The number of trustees of this corporation shall be five and the names and residences of the first trustees who shall manage the affairs of the corporation until the 1st day of July 1915, are J. McPherson, E. L. Farnsworth, Chas. Hudkins, G. Thompson, and E. H. Oswalt, all of Wilbur, Lincoln County, state of Washington.

Article Seven

The capital stock of this corporation may be transferred without restriction to any person already a stockholder therein, but shall not be transferable to any person or party not a stockholder of this company without the affirmative vote, approving such transfer, of at least two-thirds of the capital stock of this company, at a regular or special stockholders' meeting called for that purpose. In case any stockholder desires to sell all or part of the stock held by him to a person not already a stockholder of this company, he shall notify the secretary of this company in writing, stating the amount of stock he desires to sell and the price asked, and shall attach his stock certificate to such notice and give the name and address of the prospective purchaser, the secretary shall then notify all of the other stockholders of this company, and such stockholders shall have an option on said stock

at the price asked for thirty days following such notice. If none of said stockholders shall exercise their right of option at or before the expiration of said thirty days, the secretary of this company shall call a stockholders meeting in the manner provided in the by-laws for the purpose of voting upon such prospective purchaser and in case he shall be elected to become a stockholder of this corporation, the president and secretary thereof shall endorse upon such certificate of stock, under the seal of this corporation, using the form given in Article Eight herein, the fact that such prospective purchaser, naming him, has been duly elected to become a stockholder of this company, and such certificate shall then be returned. In case such prospective purchaser shall not be elected as herein provided, then said certificate shall be returned without such endorsement.

Article Eight

On every certificate of stock issued by this company, the following provision shall be printed thereon, to wit:

According to Article VII of the Articles of Incorporation of this company and an agreement entered into between the holder of this certificate and all the other stockholders of this company, this certificate is not transferable until the stockholders of this company have been given an option for thirty days for the purchase thereof and such option expired, nor can this certificate be transferred, except to the stockholders of this company, without the

consent of at least two-thirds of the capital stock voted in this company, which consent shall be endorsed hereon and signed by the president and secretary of this corporation, naming the person to whom same may be transferred, and bearing the corporate seal.

The following individuals were the original incorporators of the Company and subscribers of the 250 shares of \$100 par value stock authorized by the Company's Articles of Incorporation in the number of shares and amounts indicated:

Subscriber	No. of Shares	Amount
E. L. Farnsworth	120	\$12,000
John McPherson	105	10,500
Charles Hudkins	10	1,000
G. Thompson	10	1,000
E. H. Oswalt	5	500

None of this stock was actually paid for or issued at this time. Petitioner's incorporators subscribed to petitioner's stock in proportion to their stock interests in the Bank.

On April 5, 1915, petitioner's subscribers held a special meeting at which time they each advanced amounts of money to petitioner as "deposits" and adopted the following amendment to the by-laws regarding the aforesaid deposits:

Amendment No. 1

Article XII

The Several stockholder of the Wilbur Security Company having this day deposited with the Company the following amounts;

E. L. Farnsworth	\$96,000.00	
J. McPherson	84,000.00	
Chas. Hudkins	8,000.00	
G. Thompson	8,000.00	
E. H. Oswalt	4,000.00	\$200,000.00

Which sums are to be credited to each Stockholders "Special Stockholders Account" on the books of the Company. These accounts not to be withdrawn by any of said stockholders except by consent of two-thirds of the Capital Stock voted in this Company at any regular or special stockholders meeting.

When any stockholder sells any of his stock it is understood that \$800.00 of his "Special Stockholders Account" shall be transferred with each share of stock sold and the proper officer shall make the transfer on the books of the Company at the time the stock is transferred.

This by-law has never been amended by the corporation.

The \$200,000 advanced to petitioner on April 5, 1915, by its subscribers had been on open account in the Bank to the credit of each subscriber. Upon its advance to the petitioner, this amount was immediately redeposited by it in the Bank.

On December 28, 1916, the petitioner's board of directors held a special meeting at which time it was decided to set aside \$25,000 of petitioner's earnings as paid-in capital. At the same meeting, it was decided to issue stock certificates to the original subscribers thereof. The minutes of the meeting were as follows:

Special meeting of the Trustees of Wilbur Secu-

rity Company held this day and called to order by J. McPherson President at 3:00 P.M. All directors present. The following resolution was offered and unanimously adopted;—

Whereas the earnings of this Company are in excess of Twenty five thousand dollars:

Therefore be it resolved that \$25,000.00 be set aside as the fully paid capital stock of this Company and that certificates of Dividend. stock be issued to the several stockholders as a stock dividend as follows:

E. L. Farnsworth	115	shares
J McPherson	105	“
Chas Hudkins	10	“
G. Thompson	10	“
E. H. Oswalt	5	“
M E Hay	5	“
<hr/>		
Total	250	“

Meeting adjourned.

From 1915 to 1938, the Special Stockholders' Account totaled \$200,000 in each year and the Paid-in Capital Account totaled \$25,000 in each year, representing 250 shares of \$100 par value stock, the only outstanding stock. However, the individual interests in those accounts fluctuated during the period 1915-1938 as follows (the dollar value of the interest in the Special Stockholders' Account appearing first after the year, followed immediately by the number of shares of capital stock):

Year	E. L. Farnsworth	J. McPherson	Elizabeth McPherson	Chas. Hudkins	A. Alexander	G. Thompson	E. Oswalt	M. E. Hay
1915	\$96,000—120	\$ 84,000—105	\$	\$ 8,000—10	\$	\$ 8,000—10	\$ 4,000—5	
1916	92,000—115	84,000—105		8,000—10		8,000—10	4,000—5	4,000—5
1917	92,000—115	80,000—100		12,000—15		8,000—10	4,000—5	4,000—5
1918	92,000—115	80,000—100		12,000—15		8,000—10	4,000—5	4,000—5
1919	60,000—75	80,000—100		24,000—30	4,000—5	16,000—20	12,000—15	4,000—5
1920	60,000—75	80,000—100		24,000—30	4,000—5	16,000—20	12,000—15	4,000—5
1921	64,000—80	80,000—100		24,000—30		16,000—20	12,000—15	4,000—5
1922	72,000—90	80,000—100	4,000—5	24,000—30		16,000—20	4,000—5	
1923	76,000—95	80,000—100	4,000—5	20,000—25		16,000—20	4,000—5	
1924	76,000—95	80,000—100	4,000—5	20,000—25		16,000—20	4,000—5	
1925	76,000—95	80,000—100	4,000—5	20,000—25		16,000—20	4,000—5	
1926	76,000—95	100,000—125	4,000—5	20,000—25		16,000—20	4,000—5	
1927	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1928	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1929	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1930	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1931	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1932	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1933	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1934	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1935	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1936	72,000—90	102,000—127½	4,000—5			16,000—20	6,000—7½	
1937	72,000—90	102,000—127½	4,000—5			16,000—20	6,000—7½	
1938	72,000—90	102,000—127½	4,000—5			16,000—20	6,000—7½	

In addition to the \$200,000 in the Special Stockholders' Account, petitioner received various additional sums from 1915 through 1938. These amounts were received from the original subscribers, from stockholders and from nonstockholders. In every case, however, such nonstockholders were members of the immediate families of stockholders. The accumulation of these amounts and their source during the years 1915 to 1938 was as follows:

Nonstockholders did not participate in management or in voting for petitioner's officers. The \$200,000 in the Special Stockholders' Account, the \$25,000 in the Paid-in Capital Account, and the monies in the Special Account were invested in loans upon notes and mortgages, primarily upon real estate, in which the Bank was unable to invest. When some of the obligors could not meet the payments on the notes and mortgages, petitioner acquired title to the properties which had been held as the security for the loans. As a result petitioner acquired title to the following properties:

Description	Date Acquired	Acreage
Alexander Farm	1929 to 1933	2,781
Cameron Farm	1933	627
Edd Campbell Farm	1932	547
Grinstead Farm	1933	158
Hagen Farm	1933	315
John Hansen Farm	1932	470
B. L. Harris Farm	1932	1,098
F. A. Hudkins Farm	1932	145
Frank Nelson Farm	1931 and 1932	938
O'Shaughnessy Farm	1932	478
Osterkamp Farm	1935	1,579
Smith-Draper Farm	1932	474
	1953 less sale	20
		— 454
V. Sommers Farm	1933	359
V. Sommers Farm	1931 and 1932	621
E. A. Squire Farm	1933	79
E. A. Squire Farm	1932	1,157
R. S. Stauffer Pasture Land	1933	742

The combined book value of these farms was from \$437,039.41 to \$445,594.72, whereas the fair market value of the properties was estimated to be in excess of \$1,500,000 during the years in question. The op-

eration of these farms constituted petitioner's principal source of income.

Petitioner's surplus, dividends, salaries, interest paid on obligations not in issue, and amounts paid on the Special Account and Special Stockholders' Account from 1915 through 1938 were as follows:

Year	Surplus	Dividends	Salaries	Interest Paid on Obligations not in Issue	Amts. Paid on Spec. Acct. and Special Stockhold- er's Acct.
1915	\$ 5,058.53	\$ None	\$ None	\$ None	\$ 388.77
1916	2,228.81	25,000.00	None	None	3,701.45
1917	728.69	18,000.00	7,840.00	None	4,837.50
1918	105.43	20,000.00	6,480.00	100.00	6,279.20
1919	792.46	17,500.00	4,400.00	1,335.72	7,714.30
1920	1,876.19	7,500.00	4,400.00	8,253.93	8,770.00
1921	19,122.53	None	2,400.00	4,993.09	12,645.40
1922	18,142.34	None	4,675.00	654.60	13,341.60
1923	18,422.58	None	None	623.67	14,902.19
1924	17,855.34	None	None	118.68	12,595.15
1925	17,384.09	2,500.00	None	150.00	13,255.67
1926	21,542.22	5,000.00	None	1,348.42	13,339.12
1927	36,219.85	None	None	475.00	13,684.36
1928	48,901.34	None	None	None	12,552.66
1929	49,969.10	None	None	570.87	12,841.30
1930	53,776.75	None	None	3,152.70	13,044.00
1931	53,063.90	None	None	1,831.88	5,607.93
1932	49,636.64	None	None	1,984.60	None
1933	49,486.08	None	None	387.33	None
1934	48,861.34	None	None	80.83	None
1935	47,689.40	None	None	None	None
1936	48,675.20	None	None	None	None
1937	48,685.46	12,500.00	2,200.00	1,172.38	15,760.00
1938	48,687.22	9,585.00	None	None	16,428.00

In 1939, petitioner's income tax returns for 1937 and 1938 were examined by respondent and a defi-

ciency in income tax was proposed for that year on the basis of a disallowance of the interest deduction taken for the interest paid to the stockholders on the amounts in the Special Stockholders' Account. Petitioner filed a protest to the proposed determination and a subsequent agreement was reached whereby the tax returns were accepted as correct.

On June 5, 1939, a special meeting of petitioner's stockholders was held in which a resolution was adopted. The minutes of the meeting were, in part, as follows:

It was duly moved, seconded and carried unanimously that the Stockholders Accounts on books of Wilbur Security Company, which total \$200,000.00 shall be paid off and distributed to the owners thereof, viz:

J. McPherson,	Stockholders Account	\$102,000.00
E. L. Farnsworth,	Stockholders Account	72,000.00
G. Thompson,	Stockholders Account	16,000.00
E. H. Oswalt,	Stockholders Account	6,000.00
Elizabeth McPherson	Stockholders Account	4,000.00
		<hr/>
		\$200,000.00

and further, that the Secretary of Wilbur Security Company, G. Thompson, is hereby directed and empowered to pay off and distribute the said Stockholders Accounts to the owners thereof.

The \$200,000 was withdrawn from the Special Stockholders' Account and the same amount was redeposited with the other funds in the Special Account. This transaction was accomplished by book-

keeping entries without transferring cash between petitioner and the stockholders. From this time on, only stockholders and members of the immediate families of stockholders held interests in the Special Account.

On January 20, 1943, petitioner's board of directors passed a resolution which provided, in part, as follows:

It was duly moved, seconded and carried that all our Special Accounts Payable, on which we pay interest, shall be changed over to Bills Payable, as of January 1, 1943. That the Secretary shall prepare proper notes of the Wilbur Security Company for each of said Special Accounts Payable, dating same January 1, 1943, due one year after date, and bearing interest at rate of 5 per cent per annum. That, these said Bills Payable shall be signed for the Company by the its [sic] President and attested by its Secretary.

Following this action, the Secretary prepared bills payable to the respective holders of interests (who were all stockholders or members of their immediate families) in the new Bills Payable Account, to pay five per cent interest for one year. At the end of each year thereafter, up to 1955, petitioner's directors renewed these bills to pay a specified rate of interest or cancelled the old notes and issued new notes for the same amounts without approval from those nonstockholders who held interest in the Bills Payable Account. The directors endeavored

to fix the interest rate annually so that it would be slightly above that of the prevailing rate paid by lending institutions. At the same time, in fixing the annual interest rate, the directors took into account the petitioner's earnings. The notes remained in petitioner's possession at all times and none of the nonstockholders ever saw them, although some knew of them.

The notes executed for 1952, on December 31, 1951, were originally issued to provide for five per cent interest per annum. On November 4, 1952, the board of directors increased this interest rate to six per cent. In 1956 the nomenclature of this account was changed to Notes Payable at the advice of Laurence D. Morse, the certified public accountant who handled the books of petitioner, because the term Bills Payable was deemed to be old-fashioned.

The status of the Bills Payable Account from 1939 to 1955 and a comparison of that account to the stock account for those years were as follows:

Year	E. L. Farnsworth	Sarah A. Farnsworth	Grace Phillips	J. McPherson	G. Thompson
1939	\$169,790.55—90	\$		\$190,000.00—1221½	\$16,000.00—20
1940	157,790.55—90			187,000.00—1221½	16,000.00—20
1941	81,081.47	73,096.74—90		171,000.00—1021½	16,000.00—20
1942		99,829.80—90	44,298.60	144,000.00—1021½	16,000.00—20
1943		96,829.80—90	50,298.60	144,000.00—1021½	16,000.00—20
1944		93,829.80—90	53,298.60	144,000.00—1021½	16,000.00—20
1945		90,829.80—90	56,298.60	144,000.00—1021½	16,000.00—20
1946		75,829.80—90	71,298.60	144,000.00—1021½	16,000.00—20
1947		72,829.80—90	74,298.60	144,000.00—1021½	16,000.00—20
1948		69,829.80—90	77,298.60	144,000.00—1021½	16,000.00—20
1949		66,829.80—90	80,298.60	144,000.00—1021½	16,000.00—20
1950		63,829.80—90	83,298.60	144,000.00—1021½	16,000.00—20
1951		63,829.80—90	83,298.60	144,000.00—1021½	16,000.00—20
1952		63,829.80—90	83,298.60	144,000.00—1021½	16,000.00—20
1953		63,829.80—90	83,298.60	144,000.00—1021½	16,000.00—20
1954		63,829.80—90	83,298.60	144,000.00—1021½	16,000.00—20
1955			147,128.40—90	144,000.00—1021½	16,000.00—20

Year	E. H. Oswalt	Elizabeth McPherson	J. K. McPherson	Kate McPherson	Julia McPherson	Catherine Bernhard
1939	\$6,000.00—7½	\$4,000.00—5	\$ 8,000.00—5	\$87,000.00	\$99,390.00	\$
1940	6,000.00—7½	4,000.00—5	8,000.00—5	87,000.00	99,390.00	
1941	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	
1942	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1943	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1944	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1945	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1946	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1947	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1948	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1949	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1950	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1951	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1952	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1953	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1954	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1955	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00

The monies in the Grace Phillips account prior to 1940 were deposited there for her by E. L. Farnsworth, her father, who took care of her finances. In 1940, E. L. Farnsworth died and his stock, plus an amount in excess of \$800 per share, was then transferred to the account of Sarah A. Farnsworth, his widow. Of the remaining funds left in the Special Account to the account of E. L. Farnsworth, approximately \$69,000 were used to pay inheritance taxes. Sarah A. Farnsworth died in 1951. Her stock and interest in the then Bills Payable Account were held under that name until 1954 when they were transferred to the account of Grace Phillips, her daughter. On January 1, 1953, petitioner disbursed \$14,000 to Grace Phillips, as executrix of the Estate of Sarah A. Farnsworth, for the purpose of settling that estate. No book entry was made affecting the balance in the Bills Payable Account, or any other account. However, the interest payment on the Bills Payable Account was arrived at by subtracting the \$14,000 from the Bills Payable Account and computing the interest on the difference. The total of Bills Payable for the year was also shown as the gross amount undiminished by the \$14,000 on the balance sheet, but the minutes of the directors' meeting and the 1953 tax return reflect both the gross amount and the net amount in that account. The \$14,000 was redeposited with petitioner on January 4 and 12, 1954, by Grace Phillips to the credit of the estate.

The relationship between stockholders, and between stockholders and those owning interests in the Bills Payable Account was as follows:

D. K. McPherson	
J. McPherson	Son of D. K. McPherson
Kate McPherson	Daughter of D. K. McPherson
Julia McPherson	Daughter of D. K. McPherson
Elizabeth McPherson	Wife of J. McPherson
J. K. McPherson	Son of J. McPherson
Catherine Bernhard	Daughter of J. McPherson
E. L. Farnsworth	
Sarah A. Farnsworth	Wife of E. L. Farnsworth
Grace L. Phillips	Daughter of E. L. Farnsworth

The members of the McPherson and Farnsworth families have maintained a close, friendly relationship through the years.

From 1941 to 1955 the members of the board of trustees (or directors) consisted of five of the stockholders, as provided for by the by-laws. These were:

John McPherson	Godfrey Thompson
John K. McPherson	Grace L. Phillips
E. H. Oswalt	

Petitioner's officers from 1941 to 1955 were as follows:

John McPherson	President
J. K. McPherson	Vice President
Godfrey Thompson	Secretary

Petitioner's surplus, dividends, salaries, interest paid on obligations not in issue, and interest paid on the Special Account or Bills Payable Account from 1939 through 1955 were as follows:

Year	Surplus	Dividends	Salaries	Interest Paid on Obligations not in Issue	Amts. Paid on Spec. Acct. or Bills Pay- able Acct.
1939	\$ 51,367.39	\$ 5,000.00	\$ None	\$ None	\$17,016.90
1940	52,734.52	7,500.00	None	None	17,195.40
1941	56,741.77	7,500.00	None	203.33	21,559.50
1942	75,819.90	7,500.00	5,000.00	162.90	27,475.92
1943	69,140.93	7,500.00	5,000.00	None	27,596.75
1944	73,864.99	7,500.00	5,000.00	None	27,625.92
1945	79,082.44	7,500.00	5,000.00	None	27,625.92
1946	84,553.48	25,000.00	8,000.00	None	27,625.92
1947	98,158.21	25,000.00	12,000.00	None	27,625.92
1948	105,328.30	25,000.00	18,000.00	None	27,625.92
1949	109,838.21	25,000.00	18,000.00	None	27,625.92
1950	128,977.48	25,000.00	18,000.00	None	27,625.92
1951	129,107.95	25,000.00	18,000.00	None	27,625.92
1952	147,238.25	25,000.00	18,000.00	None	33,151.10
1953	147,541.62	25,000.00	18,000.00	None	32,311.10
1954	164,121.39	25,000.00	18,000.00	None	33,151.10
1955	166,872.50	25,000.00	18,000.00	None	33,151.10

Petitioner's balance sheet for the years in question was as follows:

	1953	1954	1955
ASSETS			
Current Assets			
Cash in bank	\$ 2,315.55	\$ 54,938.74	\$ 35,119.82
Bills Receivable	304,095.73	269,161.64	283,176.36
Investment in Stocks	500.00	500.00	500.00
Fixed Assets			
Farm properties and buildings	438,148.74	437,039.41	445,594.72
Total assets	<u>\$745,060.02</u>	<u>\$761,639.79</u>	<u>\$764,390.90</u>

LIABILITIES AND CAPITAL

Current Liabilities

	1953	1954	1955
Income tax payable, estimated	\$ 20,000.00	\$ 20,000.00	\$ 20,000.00
Notes payable	552,518.40	552,518.40	552,518.40

Capital

Capital stock	25,000.00	25,000.00	25,000.00
Surplus	147,541.62	164,121.39	166,872.50

Total liabilities and capital	\$745,060.02	\$761,639.79	\$764,390.90
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Respondent disallowed all interest deductions for monies paid as interest on the Bills Payable Account when he determined that the account represented the actual invested capital, placed at the risk of the enterprise. Also the amount of \$840 was added to petitioner's income for 1953 representing six per cent interest on the \$14,000, which was reported as an account receivable from the Estate of Sarah A. Farnsworth.

The amounts outstanding in petitioner's Bills Payable Account constitute equity capital invested in the petitioner's business. The payments of \$32,311.10 in 1953, \$33,151.10 in 1954, and \$33,151.10 in 1955 on the Bills Payable Account were distributions of dividends.

Petitioner did not realize \$840 in interest income in 1953.

Opinion

Issue 1.

Whether amounts advanced to a corporation constitute equity capital or indebtedness is a question of fact, and the issue must be decided on the facts of each individual case. *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946). Under the decided cases, some of the determining factors have been the name given to the certificates evidencing the indebtedness, the presence or absence of a maturity date, the source of the payments, the right to enforce the payment of principal and interest, participation in management, a status equal to or inferior to that of regular corporate creditors, the intent of the parties, capitalization, identity of interest between creditor and stockholder, and payment of interest only out of dividends. See *Gooding Amusement Co.*, 23 T.C. 408 (1954), *affd.* 236 F.2d 159 (C.A. 6, 1956), *certiorari denied* 352 U.S. 1031 (1957); *Isidor Dobkin*, 15 T.C. 31 (1950); *Green Bay & Western Railroad Co.*, 3 T.C. 372 (1944), *affd.* 147 F.2d 585 (C.A. 7, 1945); and *John Kelley Co.*, 1 T.C. 457 (1943), *revd.* 146 F.2d 466 (C.A. 7, 1944), *revd.* 326 U.S. 521 (1946). It is the petitioner's contention that a consideration of the above-listed factors as they existed during the years before us, 1951-1953, leads to the conclusion that a bona fide indebtedness existed. On the other hand, respondent maintains that giving proper consideration and weight to all material facts and circumstances, including those of years prior to the tax

years, will require a contrary result. We agree with respondent.

Looking only to the facts of the years in question, without regard to the circumstances of prior years, the Bills Payable Account might appear to be a bona fide indebtedness. For each account, there existed a note, bearing a stated rate of interest, and payable at a fixed maturity date, one year from the date of making the note. The ownership of the stock did not continue in the same proportion to the interests in the Bills Payable Account. Some persons owning interests in the Bills Payable Account did not own any stock, nor did they have any right to vote or participate in the management. The names on the certificates, Bills Payable, suggest an indebtedness rather than capital investment. Finally, the declared intent of the petitioner as set out in the minutes of the directors' meetings would suggest the existence of an indebtedness. However, we are satisfied that to accord determinative weight to these apparent indicia of an indebtedness without consideration of the events and circumstances of prior years, where material, would distort the true facts and obscure the reality of the arrangement here involved.

In 1915, when the corporation was first formed, the only funds petitioner possessed with which it could conduct its business was the \$200,000 advanced by the subscribers to the stock. No other property or capital was advanced to it. No stock was issued or paid for in 1915. This same \$200,000 was part of the Bills Payable Account during the years here

involved, 1953-1955. On April 5, 1915, the by-laws were amended whereby the stockholders were required to have \$800 in the Special Stockholders' Account (now part of the Bills Payable Account) for each share of stock owned by them. It was not until 1916 that the subscribed stock was in fact issued, and this subscribed stock was paid for from the first year's earnings of the business. During that year, only the \$200,000 was available and at the risk of the business so that we may conclude that the stock was paid for out of earnings on the \$200,000. In 1916, a "stock dividend" was declared in the amount of \$25,000 (the same amount as that of the original, unpaid-for stock subscriptions) and this \$25,000 was then set aside as the paid-in capital on the company books. Thus, it is obvious from these circumstances that the \$25,000 in reality represented earned surplus rather than actual paid-in capital. The original \$200,000 remained the sole risk capital of the enterprise. The ratio of the stated capital of \$25,000 to the so-called Special Stockholders' Account of \$200,000 was eight to one, a fact indicative that the entire \$200,000 was at the risk of the business. See *R. M. Gunn*, 25 T.C. 424 (1955), *affd.* 244 F. 2d 408 (C.A. 10, 1957), *certiorari denied* 355 U.S. 830 (1957); and *Gooding Amusement Co.*, *supra*. In the first years of petitioner's existence, there was no written evidence of the alleged indebtedness, no obligation to pay interest, no maturity date, no right to enforce payment of interest or principal, and there was an absolute proportionate interest between stock and the

Special Stockholders' Account, required by the by-laws, which continued through 1939.

The \$200,000 had been withdrawn originally from the Bank for the purpose of using it to make long-term loans, which the Bank could not make because of loan restrictions. Petitioner also argues that the stockholders originally withdrew the \$200,000 from the Bank because the presence of the large deposit on hand at the Bank would lure other competing banks into the small community. However, once the money was withdrawn from the Bank and advanced to petitioner, it was immediately redeposited in the Bank to the account of petitioner. In view of this circumstance, it is difficult to find much substance in the argument.

Under all the circumstances of this case, we are satisfied that there was no separate identity between the stated capital and the loan account of \$200,000. In fact, the stated capital owes its very existence to the loan account.

In 1939, the \$200,000 Special Stockholders' Account was transferred to the Special Account. Petitioner contends that the Special Stockholders' Account was liquidated at that time and that the stockholders then chose to reloan the money to petitioner. However, aside from the resolution passed at a meeting of the stockholders in 1939, there is no record of the amounts being distributed in fact to the interested parties, but there was merely an entry on the books whereby the Special Account was credited and the Special Stockholders'

Account was debited. It is significant that petitioner made these entries only after respondent had examined its books and questioned the claimed interest payments on the \$200,000. Moreover, the proportionate interest of stock to the original loan, now part of the Special Account, continued following the bookkeeping changes in 1939. For every share of stock held, there remained \$800 in the Special Account to the account of the particular stockholder.

In 1943, petitioner converted the Special Account to the Bills Payable Account at the advice of its accountant. For the first time, notes were made reflecting the amounts in the account. These notes bore a stated rate of interest, and a maturity date of one year from the date they were made. However, these notes remained in the possession of the petitioner, and no nonstockholder saw them, although some knew of their existence. At the end of each year, either the notes were marked paid by one of petitioner's officers and new notes issued for the same amount, or the old notes were simply renewed. These transactions were accomplished without the concurrence of those, other than stockholders, owning interests in the Bill Payable Account. The interest rate actually varied from year to year and this variation took into consideration the earnings of the business during the year prior to the date the notes were made. In 1952 the notes were altered by the petitioner, two months before the payment date, without conferring with the persons who held interests in the Bills Payable Account, so

as to increase the amount of interest payable at the maturity date of the notes. The similarity of this action to the declaration of an extra, or year-end, dividend seems more than coincidental.

We note that the account of Sarah A. Farnsworth in the Bills Payable Account during the years 1948-1954 did not have \$800 for each share of stock held by Sarah A. Farnsworth or her estate. The account did have at least \$709.22 for each share of stock owned by Sarah A. Farnsworth or her estate. However, Grace Phillips, the daughter of Sarah A. Farnsworth and the individual who conducted the business affairs of her mother, had sufficient amounts to her own credit in the account to equal the required \$800. Grace Phillips was a member of the board of directors from 1941 through the years in question, although she was not an actual stockholder until 1955 when stock was transferred to her account from her mother's estate. Under these circumstances and in view of the great weight of the other evidence, the fact of Sarah A. Farnsworth's somewhat disproportionate interests, is insufficient to alter our conclusion that the \$200,000 represented equity capital.

As we have found, from 1915 through the years in question, amounts were deposited with petitioner in addition to the original \$200,000 and some of these amounts were placed to the credit of persons other than stockholders. However, the only non-stockholders having such credits were members of the Farnsworth and McPherson families, these two families controlling at least two-thirds of the cor-

porate stock at all times. Aside from the absence of voting rights and participation in management, there were no distinctions between the \$200,000 account and the Special Account. However, the lack of voting rights and participation in management is also common to certain kinds of stock. *Green Bay & Western Railroad Co.*, *supra*; *Commissioner v. H. P. Hood & Sons*, 141 F. 2d 467 (C.A.1, 1944), affirming *H. P. Hood & Sons, Inc.*, a Memorandum Opinion of this Court filed December 2, 1942. When the Special Stockholders' Account and the Special Account were combined in 1939, it did not affect the nature of the Special Account any more than it did the nature of the amounts previously in the Special Stockholders' Account. The issuance of the notes on the Bills Payable Account in 1943 likewise did not affect the nature of the account, since there were no changes as to control, rights to interest and recovery, or as to true maturity date. As was the case with respect to the original \$200,000, the rate of interest varied from year to year at the discretion of the board of directors who took into account the petitioner's earnings in fixing the rate. We are satisfied that the effect of the written notes, the stated maturity dates, interest rates and the disproportionate interest of stock to the Bills Payable Account served only to disguise the true nature of the amounts in that account. The amounts held by petitioner in the Bills Payable Account, above the original \$200,000 capital of the corporation, represent additional capital, and were at the risk of the business.

The amounts paid on the Bills Payable Account during the years in question constituted dividends and not deductible interest.

Issue 2.

Respondent has determined that petitioner realized \$840 interest income in 1953 on the \$14,000 outstanding loan to the Estate of Sarah A. Farnsworth. Petitioner argues that it did not charge any interest to the estate and is not required to do so for income tax purposes. *Combs Lumber Co.*, 41 B.T.A. 339 (1940). Nor is it required to accrue interest, where there existed an understanding that none would be charged, even though there existed a note bearing a stated interest rate. *Society Brand Clothes, Inc.*, 18 T.C. 304 (1952). However, here there was no note, and we conclude, consistent with the rest of this opinion, that the \$14,000 represented simply a withdrawal of capital, later reinvested. This being the case, petitioner is not chargeable with having realized interest income on that amount.

Decision will be entered under Rule 50.

Served February 2, 1959.

[Title of Tax Court and Cause.]

ORDER

It is

Ordered: That the second paragraph of the Headnote of the Findings of Fact and Opinion herein,

31 T.C. No. 92, filed January 30, 1959, be and it hereby is amended as follows:

Held, further, petitioner did not realize \$840 interest income from amount temporarily withdrawn by one of its stockholders.

Dated: Washington, D. C., February 4, 1959.

[Seal] /s/ RUSSELL E. TRAIN,
 Judge.

Served February 6, 1959.

Tax Court of the United States
Washington

Docket No. 68408

WILBUR SECURITY COMPANY,
 Petitioner,
 vs.

COMMISSIONER OF INTERNAL REVENUE,
 Respondent.

DECISION

Pursuant to the Findings of Fact and Opinion filed January 30, 1959, the respondent and petitioner herein having filed an agreed computation on March 10, 1959, now therefore, it is

Ordered and Decided: That there are deficiencies in income tax for the taxable years 1953, 1954, and

1955 in the amounts of \$13,520.46, \$17,254.17, and \$17,254.18, respectively.

Entered: March 13, 1959.

[Seal] /s/ RUSSELL E. TRAIN,
Judge.

Served March 16, 1959.

In The United States Court of Appeals
For The Ninth Circuit

Tax Court Docket No. 68408

WILBUR SECURITY COMPANY,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REVIEW

Wilbur Security Company, Petitioner in this cause, hereby files a Petition for Review by the United States Court of Appeals for the Ninth Circuit of the decision by the Tax Court of the United States entered March 13, 1959 (Opinion filed January 30, 1959, Amended February 4, 1959) reported at 31 T.C. . . . , No. 92, determining deficiencies in Petitioner's federal income taxes for the taxable years 1953, 1954, and 1955, in the amounts of \$13,957.26, \$17,254.17, and \$17,254.18, respectively. This

Petition for Review is filed pursuant to provisions of Sections 7482 and 7483 of the Internal Revenue Code. The Petitioner respectfully shows as follows:

I.

Allegations of Venue

Petitioner is a Washington corporation with its principal office located in the City of Wilbur, Washington. For each of the taxable years 1953, 1954, and 1955, Petitioner timely filed its corporate tax returns with the District Director Internal Revenue at Tacoma, Washington. Venue is conferred upon the Circuit Court of Appeals for the Ninth Circuit by virtue of the above facts and Section 7482(b) of the Internal Revenue Code.

II.

Nature of The Controversy

This case involves the oft litigated question of the deductibility, for federal income tax purposes, of certain payments made by Petitioner in each of the taxable years 1953, 1954, and 1955, i.e., whether such payments represent nondeductible dividends or whether the payments represented interest which Petitioner could deduct in arriving at taxable income for the said years. The facts underlining the controversy are as follows:

Wilbur Security Company was organized in 1915 as a Washington corporation with its principal office in Wilbur, Washington. Its authorized capital was \$25,000. At the time of incorporation, \$200,-

000 was deposited with the corporation in a "Special Stockholders' Account". From 1915 to 1938 the "Special Stockholders' Account" remained on the books of the corporation. In addition to the \$200,000 in the "Special Stockholders' Account", the Petitioner borrowed other moneys from stockholders and other individuals. In 1938 the total advances to the Petitioner, over and above the said \$200,000, was \$356,230.55, which said amount was placed in an account labeled "Special Account".

In 1939 the said "Stockholders' Account" and the "Special Account" were consolidated under the heading of "Special Account" and the amounts remained in this account until 1942. In 1942 the amount outstanding in the "Special Account" was approximately \$549,518.40, of which \$293,829.80 had been obtained from stockholders of the company and \$255,688.60 was obtained from persons who owned no stock interest in the Petitioner.

In 1943 the said "Special Account" was changed to "Bills Payable". Notes were issued to the owners of the funds in the said "Bills Payable" account carrying interest at the rate of five per cent (5%) and calling for payment in one year. Notes evidencing the amounts in the "Bills Payable" account were in existence during each of the taxable years 1953, 1954, and 1955, and interest was paid annually by the Petitioner on the said amounts.

The amount outstanding in the "Bills Payable" account during each of the taxable years 1953, 1954, and 1955, was \$552,518.40. Of this amount, some 53.34 per cent had been advanced by persons who

were not stockholders in the Petitioner and had no voice in the management and did not share in the earnings of the Petitioner. During the taxable years 1953, 1954, and 1955, the ownership in Petitioner's stock and bills payable was not proportionate.

Petitioner always treated the amounts outstanding in the "Bills Payable" account as loans. This consistent treatment was maintained even during the excess profits tax years when it would have been advantageous tax-wise to treat the amounts as paid-in capital. The amounts in the "Bills Payable" account were never subordinate to other creditors. During each of the taxable years 1953, 1954, and 1955, the fair market value of the assets of the Petitioner was in excess of \$1,500,000.

In 1953, one of the stockholders died. At this time the stock of the Petitioner, for estate tax purposes, was valued at \$2,300 a share. The value was agreed to between the Internal Revenue Service and the deceased stockholder's estate.

For the taxable years 1937 and 1938, an agent of the Internal Revenue Service disallowed, for tax purposes, the interest deductions to the Petitioner on the amounts then outstanding in the stockholders' account. The Internal Revenue Service took the position that the amounts paid as interest on this account were, in fact, dividends. After conference with the Appellate Division, the Internal Revenue Service accepted the tax returns as filed by the Petitioner for the said taxable years.

In 1953, 1954, and 1955, the Internal Revenue Service again took the position that the interest

payments were not deductible by Petitioner in arriving at taxable income. A deficiency in tax was asserted for the said taxable years based principally upon the disallowance of the interest as a deduction.

The Tax Court of the United States held that the entire amount outstanding in the Petitioner's "Bills Payable" account for each of the years 1953, 1954, and 1955, constituted equity capital invested in the Petitioner's business and that the amounts paid by the Petitioner on this account, and deducted as interest, were in fact the distribution of a dividend.

III.

The said taxpayer-corporation being aggravated by the Findings of Fact and Conclusions of Law contained in the Findings and Opinion of the Tax Court, as referred to above, and by its Decision entered pursuant thereto, desires to obtain a review thereof by the United States Court of Appeals for the Ninth Circuit.

The interest payments made by the corporation in each of the taxable years, 1953, 1954, and 1955, were deductible by the Petitioner in arriving at taxable income and the amounts outstanding in the "Bills Payable" account during each of those said taxable years represented loans to the company and not equity capital.

/s/ PAUL CASTOLDI,

/s/ FRANCIS J. BUTLER,

Counsel for Petitioner.

Duly Verified.

I, Francis J. Butler, one of the counsel of record for the Petitioner in the within proceeding, do hereby certify that I served a true copy of the Petition for Review on Arch M. Cantrall, Chief Counsel, Internal Revenue Service, Washington, D. C., by mailing to him on this date a true copy thereof, addressed to him at such address.

/s/ FRANCIS J. BUTLER.

Subscribed and sworn to before me this 21st day of April, 1959.

[Seal] /s/ WILLIAM G. ENNIS,
Notary Public in and for the State of Washington,
residing at Spokane.

[Endorsed]: T.C.U.S. Filed April 24, 1959.

[Title of Tax Court and Cause.]

CERTIFICATE

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 18 inclusive, constitute and are all of the original papers on file in my office as called for by the "Designations", including exhibits 1-A through 22-V and 24-X through 43-QQ attached to the stipulation of facts, joint exhibit 23-W, admitted in evidence, petitioner's exhibit 44, admitted in evidence, and exhibits 45-RR through 47-TT attached to the supplemental stipulation of facts, in the case before the Tax Court of the United

States docketed at the above number and in which the petitioner in the Tax Court has filed a petition for review as above numbered and entitled, together with a true copy of the docket entries in said Tax Court case, as the same appear in the official docket in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 26th day of May, 1959.

[Seal] /s/ HOWARD P. LOCKE,
Clerk, Tax Court of the
United States.

The Tax Court of the United States

Docket No. 68408

WILBUR SECURITY COMPANY,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

TRANSCRIPT OF PROCEEDINGS

Courtroom 815, United States Courthouse, Seattle, Washington, Monday, March 17, 1958.

The above-entitled matter came on for hearing, pursuant to notice at 2:45 o'clock p.m.

Before: The Honorable Russell E. Train.

Appearances: Francis J. Butler, Esq., and Paul Castoldi, Esq., 811 Paulsen Building, Spokane, Washington, appearing for the petitioner. George E. Constable, Esq., 211 U. S. Courthouse, Seattle, Washington, appearing for the respondent. [1]*

Proceedings

The Clerk: Docket No. 68408, Wilbur Security Company.

Mr. Constable: Your Honor, George E. Constable for respondent.

We have considerable data, we have a lengthy stipulation of fact which I think is ready. I wonder if we may have five minutes to assemble this data.

The Court: The Court will stand in recess for ten minutes.

(Short recess.)

The Clerk: The Court will proceed with the trial of Docket No. 68408, Wilbur Security Company.-

Mr. Butler: Mr. Paul Castoldi and Francis J. Butler appearing on behalf of petitioner.

Mr. Constable: George E. Constable for respondent.

Mr. Butler: If it please the Court, we have a rather voluminous stipulation of facts and also a deposition that has been taken pursuant to stipulation of the parties. I thought it might be a good idea, since Your Honor hasn't this stipulation of facts, to give you a short opening statement.

The Court: Proceed.

* Page numbers appearing at top of page of Reporter's Transcript of Record.

Opening Statement On Behalf of the Petitioner by
Mr. Butler:

Your Honor, this case involves the taxable years 1953, '54, and '55. The principal issue is one that I am sure the Court is familiar with, the disallowance of an [3] interest payment on certain amounts outstanding in which the question is, the old question of thin incorporation. Fortunately we are not bothered by any voluminous statutory provisions because it is all case law, there is nothing in the statute on it.

The only other minor issue concerns an interest payment of \$850. We have pleaded that small depreciation issue in the petition, which we are not contesting. The deficiency is somewhere in the neighborhood of \$50,000, but it is more than that really because it is a continuing issue, one which is extremely important to the petitioners herein.

Of course, since it is strictly a factual situation, there are a great number of cases that have been decided on it and each one has its own peculiar facts. This case is certainly no exception in that. The only thing you can do is glean certain things from those cases by way of facts. I would say that we think that the certain elements set out in the case law are very favorable to our position.

I would just briefly like to state a rough outline of the facts for the Court.

This isn't a Kelly-Talbot type case where there is any question of whether the notes or the evidences

of indebtedness have any indicia of ownership, it is a strict, as I see it, pure thin incorporation question, there is no doubt about what the notes provide, they're stipulated in evidence. [4]

In 1950, which was some 18 months after the first Internal Revenue Code of 1913 was enacted, the corporation, Wilbur Security Company, was organized. It was organized by some gentlemen who were also interested in a small bank in the City of Wilbur in the State of Washington. Stock was subscribed for but not issued until 1916. At this time there was a dividend paid and \$25,000 of capital was paid in. They deposited at that time \$200,000 in what comes to be known in the stipulated facts as a stockholders' special account. This special account, this \$200,000, remained on deposit with the Wilbur Security Company until 1938. In the meantime through the years the corporation obtained other amounts which are also a subject of the stipulated facts, or/and above the \$200,000, and the additional amounts which had been obtained from certain individuals were consolidated into what became known as a special account, and that account remained unchanged until sometime in 1942, as the stipulated facts will show, the nomenclature of this account was changed over to what becomes known in the stipulated facts as the bill payable account, the same balances having been transferred over per books by cash.

Of course at that time in 1943, notes were issued evidencing the amounts outstanding in that account,

also, I might add, calling for a time certain payment and an interest payment. These notes were renewed through the years. Some years they were, in the later years they were merely [5] re-issued without tearing up the old note or anything, but nonetheless, the notes were in issue outstanding all these years. Interest was paid on these amounts.

In 1938 this same question of thin incorporation was before the then technical staff and they resolved the question in favor of the taxpayers.

I think that the facts will show that the intent of these people in putting this money up was quite clear that they intended that the money come back and it wasn't at the risk of the business, wasn't subordinate to other amounts, and, furthermore, they had every reason to believe it would come back. I don't think, despite the theory of the case, that there is any thinness. In 1952, for example, the book value or the fair-market value of the assets of this company were, as we will show, in excess of a million dollars. The amount outstanding in the bill payable account at that time was five hundred thousand. In addition to that there was surplus available of some hundred and sixty thousand.

Aside from those facts, another very important fact from the cases is the fact that these loans and stock ownership are not pro rata. As a matter of fact, I think it is safe to say on the stipulated facts that over 50 per cent of these interest payments on the taxable years involved herein which are disallowed were interest payments to people who are

not even stockholders of the Wilbur Security Company, the [6] petitioner herein.

As I say, the question of course becomes whether you look back to 1915, but certainly we don't think that that is what you do. We think we have got some pretty good case law that we will point out in brief and you look at the issues, what they were at that time. The paid-in capital and the fair-market value of the assets, if that is done, as I think should be, there is no question about the inadequacy of the capital of this company.

I would just conclude by saying that when your Honor hears the evidence we feel that you will hold as we think you should hold that these amounts were absolutely and without a question loans and that the disallowance of the interest on the thin capitalization theory or any other theory by the government is erroneous.

The Court: Thank you.

Mr. Constable.

Mr. Constable: Your Honor, that was a very good statement of the issues. I liked Mr. Butler's reference particularly to the issue on the depreciation.

Can we stipulate that you are conceding that, Mr. Butler?

Mr. Butler: I think the issue involves \$30 and we will agree that there is no contest as far as that is concerned. We have abandoned our assignment of error in the petition. [7]

Opening Statement On Behalf of the Respondent
by Mr. Constable:

Your Honor, I think by now you have a good idea of the primary issue involved. There is much more to the facts than Mr. Butler has indicated. The government will show and the exhibits will show that the notes—oh, and incidentally, on those notes we have stipulated and very carefully stipulated that the notes were executed. We have not stipulated that the notes were delivered or negotiated or anything other than that they were brought into existence. They were printed forms which the president of the corporation signed as notes payable. We think that the notes themselves and the funds which they represent are part of the capitalization of this corporation and that the increments attributable to that capital should flow out of this organization as a dividend and not as interest. We will see how the board of directors of the board of trustees deals with these notes more or less as it sees fit.

And also another factor to be considered is the close family relation involved between the stockholders, the people who are stockholders, officers, and directors. There are, it is true, what you would term outsiders who are not, who have advanced, or placed funds with this organization that are in issue, who are not officers, they're not stockholders, but they happen to be people who are closely related to stockholders or officers. [8]

I think, unless your Honor would care to hear more of the detail that is contained in our stipula-

tion of facts, and perhaps some of the things that will be developed in the evidence, I will let my opening statement as to what is to come close at this point.

We do have some additional matters. I have some objections in the deposition when it is offered and I have some objections within the stipulation of facts, those matters pertaining to relevancy of exhibits primarily.

Mr. Butler: I would then offer at this time as a part of the record in this case a 12-page stipulation of facts with Exhibits 1 to 43-QQ attached thereto, which is executed on behalf of—

The Clerk: Joint exhibits?

Mr. Butler: Yes.

We would like to withdraw for the purposes of photostating, 14-N, Exhibit 29-EE to Exhibit 36-JJ, which are the notes and I believe Mr. Constable doesn't have a copy of those either, so—

Mr. Constable: Your Honor, I will make a request to withdraw—I would rather wait until the close of the hearing because there may be some additional exhibits that I would wish to withdraw.

Now, the stipulation, that's been offered for filing.

The Court: I haven't accepted it yet. I want to [9] understand a little further concerning your position as to your objections.

Mr. Constable: I have no objection with the exception of certain exhibits and I believe one paragraph which does not have an exhibit.

The Court: The stipulation of facts together

with the exhibits attached thereto is received subject to respondent's objection.

The parties may upon request of the clerk and giving to him of a receipt, withdraw any original documents and substitute photostats therefor.

Mr. Butler: Thank you, your Honor.

Mr. Constable: Does the Court wish to hear my objections at this point?

The Court: Are these to items in the stipulation of facts?

Mr. Constable: To items in the stipulation of facts, that is correct, your Honor.

The Court: The Court, I don't believe that the Court should rule at this time on any of those objections. I would suggest that it is appropriate that you submit your objections along with your brief. Would that be agreeable?

Mr. Constable: I think on these particular exhibits that if the Court takes them under those conditions I doubt that I would have additional evidence to counteract them in [10] the event they are received or given great weight.

The Court: In other words, my holding a ruling in abeyance will not interfere with your conduct of the trial?

Mr. Constable: That is correct. That is because, your Honor, they are so remote and irrelevant that it will make very little difference in the proceeding.

Mr. Butler: I won't embarrass the respondent by asking him to make his objections in open court. I think he would prefer to do that.

(Petitioner-Respondent Exhibits Nos. 1 to 43-QQ were received in evidence.)

The Court: Is petitioner ready to proceed?

Mr. Butler: I would also like to request at this time the original deposition in Docket No. 68408 which was taken on behalf and at the instance of the petitioner in Seattle, Washington, on November 8, 1957, the testimony of Grace Lewis Phillips and Mr. John McPhearson, and I would like to offer the deposition under the rules as evidence and part of the record in this proceeding.

Mr. Constable: Your Honor, I have some objections here to the deposition.

The Court: Are they noted in the record?

Mr. Constable: They are all noted with the exception of an objection which I will make for the record at this time.

Your Honor, I think I will withdraw that remark. No [11] objection was noted and, as I understand, under the rules we waive all objections except materiality and relevancy, therefore I will withdraw that remark.

However, I will object to, in the deposition of Grace Lewis Phillips, page 7, line 11, the question beginning, "Now would you, if you had been requested, have subordinated this amount in the loan account to other creditors?"

I also object to the deposition of John McPhearson, page 9, the question beginning at line 15, "If the Company had gone defunct for some reason would your amount in the special account have taken precedence over the stock account". And

in the same deposition at page 27—correction—I will withdraw my objection to page 27, but further object in the same deposition, page 43, to the question beginning at line 9, and to the line of questioning following with regard to the \$2,300 evaluation. That objection is not noted, but I make my objection on the grounds of its relevancy. And in the same deposition, at page 40—

The Court: You said and in the line of questioning following. Is that sufficiently clear on the record so I know where your objection goes?

Mr. Constable: I think it is and it is the same question that will come up in perhaps five or six exhibits in the stipulation of facts.

The Court: Thank you. [12]

Mr. Constable: In the same deposition at page 45, question on line 1, "What in your opinion would be the fair-market value of these properties?"

And in the same deposition, page 46, the question beginning at line 13—correction—line 12, the question beginning, "Now, as a noteholder in the Wilbur Security," et cetera.

Those are all the objections I have to the deposition, your Honor.

The Court: The deposition will be received subject to the objections of respondent.

Mr. Butler: Would your Honor prefer that I argue my evidence now or at the time of the briefs?

The Court: I suppose it would keep the record clearer to argue it now.

Mr. Butler: I can briefly note, then, if I may.

The Court: If we are going into this the Court may be in a position to go ahead and rule.

Mr. Butler: That is why we made the opening statement first.

I can just note them, your Honor, and if you want to reserve your ruling there is certainly nothing wrong with that, it won't restrict us in any way I am sure.

The first objection that Mr. Constable noted was on page 7 of the deposition. The question, "Now, would you, if [13] you had been requested, have subordinated the amount in the loan payable account to other creditors?" The question was objected to as calling for a possible state of minor conclusion of the witness. The witness Grace Lewis Phillips is a noteholder in the Wilbur Security Company and certainly as such is entitled to testify as to her intent, since intent is really the crux of this whole matter. That is a question she can answer, it is her own state of mind, but that is the only thing that is important, what she would have done.

The Court: Mr. Constable.

Mr. Constable: If your Honor please, you will note that the objection is also on the ground that it is a hypothetical question. The question reads, "Now, would you, if you had been requested, have subordinated this account in the loan account of other creditors?" There is nothing to indicate that this witness had ever been requested to perform this particular act. Mr. Butler's question was predicated on facts that were purely hypothetical.

Mr. Butler: I would submit, your Honor, that you can certainly ask a hypothetical question of a party who is clearly in this thing as Grace Lewis Phillips. She had her own indications as to how she felt the account was to be treated and she so testified for what it is worth.

The Court: The objection is overruled.

Mr. Butler: The next objection was in the deposition [14] of Mr. J. McPhearson, which was on page 9 of his testimony, the question reading, "If the company had gone defunct for some reason would your amount in the special account have taken precedence over the stock amount?" Again, your Honor, the objection was that it called for a conclusion.

The Court: I don't see the question on page 9.

Mr. Butler: Line 15.

Mr. Constable: This deposition has moved, the second witness is in the back of the deposition, J. McPhearson. If you will note at the bottom of the deposition there are two witnesses, a Phillips and a McPhearson.

Mr. Butler: Yes, I am sorry, I didn't clear that up, your Honor.

Mr. Constable: The numbers begin at one for each witness.

Mr. Butler: The objection to that was that it called for a conclusion and the respondent objected. Again, Mr. McPhearson during the years involved herein, I think I am correct in saying that he was both a noteholder and a stockholder in the Wilbur Security Company, and certainly his intent with

regard to how he felt, what his thought was, on this amount is important and he is simply being asked in his own opinion or whether he thought or in his own intent if the corporation for some reason couldn't pay off everything whether he would, because of this noteholding, come in ahead [15] of the stockholders, of which he was one.

Mr. Constable: Your Honor, the question reads, "If the company had gone defunct." Now, I take it, the word "Defunct" is tantamount to bankruptcy, "If the corporation had gone defunct for some reason would your amount in the special account have taken precedence over the stock account?" That is strictly a question for the courts to determine who would take the precedence over the remaining assets of this corporation if it became insolvent. Mr. McPhearson was not competent to express an opinion on that matter of law.

Mr. Butler: Mr. McPhearson was competent to express an opinion on how he felt, since the intent is the crux of this matter.

The Court: The objection is sustained.

Did this discussion cover the second question?

Mr. Butler: That of subordination, your Honor.

The Court: I note here two questions and two objections. Now, they're right together. I think it is basically the same question and the same objection.

Mr. Constable: There was an objection, your Honor, that I intended to make on page 6 but I abandoned it.

The Court: I am speaking of the question, "Would the amount outstanding in the special ac-

count have been prior to the stock ownership if the company had followed up," then there was an objection. [16]

Mr. Constable: That is correct, your Honor.

The Court: Then another question, "Would you in effect be ahead of the stock by virtue of this special account?" Then another objection. As I understand, the record here it is unclear.

Mr. Butler: I will certainly go along with that first objection above because the answer was, "No." So I am in full accord with that. I think it is safe to say the two go hand in hand.

Is that right, Mr. Constable?

The Court: The objection is sustained.

Mr. Butler: The next objection noted is for a line of questioning at page 3, and here on redirect examination we developed, or tried to develop, the fact that there had been, this stock in the Wilbur Security Company had been evaluated for state tax purposes in an agreement between the government and the executrix of one of the parties. Again I think that is evidence that is certainly relevant. In the estate of Herbert Miller, which was a Ninth Circuit case, the valuation by the government of stock in the taxpayer company was given great weight by the Ninth Circuit Court. I certainly think that what the government thought the stock was worth at that particular point is indeed material and relevant to this controversy.

Mr. Constable: Your Honor, this particular objection [17] now is the one which will arise in the

stipulation of fact again. It appears obvious from the question that what is involved is that the witness' wife died and they had a problem of evaluating the stock of the corporation that is here involved. Mr. Butler has made that or is attempting to make the market value of that stock an issue in this case. Assuming that is material, assuming that it is relevant to this proceeding to determine the market value of the stock, I submit that an offer in settlement which is accepted should not be relevant in a proceeding of this sort to determine here what the value of that stock is. How do we know what the parties did when they negotiated the settlement of the \$2,300. There may have been other considerations, other factors, which would tend to have caused a \$2,300 evaluation to be placed on the stock for purposes of settlement in that particular proceeding. We are here litigating the value of this stock. Mr. Butler is attempting to prove its value by what other parties did in another controversy at a time during which we have no knowledge of the negotiations leading up to the eventual settlement at \$2,300.

Mr. Butler: Well, I would certainly say that true, the parties got together and agreed, there may have been other things, but the government said at that time, which is a material time herein, that the stock was worth \$2,300 a share and we certainly know that the revenue agents in the field are [18] not giving the taxpayers' money away. As I repeat, the valuation of stock in a thin incorporation case on or about the time of the interest disallowance

was a material factor in the Ninth Circuit opinion in the Herbut Miller case.

The Court: You will have to give the Court an opportunity to read this. It will take a minute or so.

Is this particular objection noted on the record?

Mr. Constable: Your Honor, the objection goes on the grounds of relevancy, which I understand according to the court's rules can be raised without being noted at the time of hearing. There is one interesting aspect.

The Court: The thing I am trying to get to here is the question that was finally objected to in the record didn't seem to involve the question of the settlement but the question as to thin market value in the witness' opinion as to certain farm land, is that right?

Mr. Butler: Again I think I have confused you, I am sorry, your Honor.

The Court: I don't know who has, but somebody has.

Mr. Butler: This is the objection at page 43. It is the line of questioning beginning, "Did you have any controversy with regard to the valuation of the stock in the Wilbur Security Company with the Internal Revenue Service at the time your wife died?" I think Mr. Constable said he objected to that line of questioning and I take it that that goes down to [19] the answer at the bottom of page 43.

The Court: Is that correct?

Mr. Constable: That is correct.

The Court: The objection is overruled.

Mr. Butler: I guess the last objection, your

Honor, is with regard to the line of questioning on Mr. McPhearson's opinion as to the fair market value of the farm properties held by Wilbur Security Company during the taxable years '53, '54 and '55. Now, Mr. McPhearson testified that he was familiar with the real estate values, the record shows he's been in the banking business and in and around Wilbur since 1903, he's had a great deal of experience with this, he was simply asked in his opinion the fair market value. He certainly gave it. He said in his opinion it would be worth over a million dollars. We have other testimony on the fair market value of this testimony. I am not——

Mr. Constable: Mr. Butler said he has other testimony. It is this particular testimony of Mr. John McPhearson that we are concerned about.

Mr. Butler: I didn't mean it that way, Mr. Constable. I meant that——

Mr. Constable: Yes.

The objection, your Honor, is based on the grounds that Mr. John McPhearson, the witness, has not been qualified as an expert to testify as to market value of this property [20] and it is based on the grounds that his statement is an opinion.

Mr. Butler: The objection in the record is to the fact that he's asked this question without identifying the farms, their locations, their nature, their acreage, and related matters, he was then asked, "I am speaking about the farms owned during the years '53, '54 and '55, owned by the Wilbur Security Company." Now, is this a new objection? I am sorry, I am confused now.

Mr. Constable: The objection is made on page 44 and is not the one in issue. I will withdraw that objection. The objection referred to is the one on the top of page 45.

It is true, your Honor, that there the reason for the objection is not noted in the record. I am in error, your Honor. Technically the objection goes to the competency of Mr. John McPhearson and we have not objected to that. I will withdraw it and save the Court a ruling.

The Court: Does that dispose of all the objections?

Mr. Butler: I think it does, your Honor. It did of the ones I kept track of.

Mr. Constable: Was there not an objection on page 46?

Mr. Butler: Of Mr. McPhearson's testimony?

Mr. Constable: Yes.

Mr. Butler: Yes, I am sorry.

The question reads, "As a noteholder in the Wilbur [21] Security Company, when I say noteholder I have in mind either the stockholder account, during these years the special account, or the note account, during the depression years if you had taken your money out of the Wilbur Security Company could you have loaned that money to somebody else at the same interest rate?" The objection is calling for a conclusion and not for a fact. I believe Mr. McPhearson, who, as I say, had been in the banking business since 1903, could render an opinion, a conclusion on that question.

Mr. Constable: Well, your Honor, I will stand on the objection. Mr. John McPhearson was asked whether or not he could have loaned the money to someone else at the same interest rate. I assume the question is the same as asking Mr. John McPhearson what the interest rate was in that year, in his opinion what would be the going market rate.

Mr. Butler: Well, just to clear it up, we signify that this is during the depression years and it wasn't at all hard to loan money during those years. The next question I think ties it in, "Could you have loaned it with the same security behind the loan as you had at the Wilbur Security Company?" And he said, "I don't think so, I don't think so, we had a lot of assets in the company," which I think is of some materiality and relevancy to this proceeding.

The Court: The objection is overruled.

Mr. Constable: I think that is all there are, then, [22] your Honor, in the deposition.

Mr. Butler: Yes, that is correct.

The Court: Then the deposition is received subject to the rulings that the Court has made with regard to various objections.

[See page 125.]

You may call your witness.

Mr. Butler: I would now call Mr. J. McPhearson to the stand, please.

Whereupon,

JOHN K. McPHEARSON

called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name, please.

The Witness: My name is John K. McPhearson.

Direct Examination

Q. (By Mr. Butler): Would you state your address? A. Wilbur, Washington.

Q. And your occupation for the record?

A. Banker.

Q. Now, you are the J. K. McPhearson that is referred to in these various exhibits that we have stipulated. Would you for the purposes of the record explain your relationship with the other people involved herein, the other McPhearsons, that is, your grandfather, your father, your sisters? [23]

A. D. K. McPhearson was my grandfather. J. McPhearson is my father. Are there any others you wish?

Q. Your mother?

A. My mother was Elizabeth McPhearson.

Q. Your sister?

A. My sister is Catherine Bernhard.

Q. Now, what is your position, Mr. McPhearson, in the Wilbur Security Company?

A. My current position is president of the Wilbur Security Company.

Q. What is your current position in the Wilbur State Bank?

(Testimony of John K. McPhearson.)

A. I am also president of the Wilbur State Bank.

Q. During the years 1953, '54, and '55, what was your position in both of these organizations?

A. I was vice-president in both of the organizations.

Q. Were you on the board of directors?

A. Yes, I was also on the board of directors.

Q. During these years? A. Yes.

Q. Now, you know we are talking here about the Wilbur Security Company and the government's position with regard to these interest payments. When did you first become a stockholder in the Wilbur Security Company? A. 1939. [24]

Q. When did you first become a billholder or noteholder? A. In the early 1930's.

Q. Now, the stipulated facts show that in 1943 an account was opened called the bill payable account. My question is when were bills evidencing the amounts first issued to the best of your knowledge? A. In 1943.

Q. The notes are in evidence and I won't withdraw them and confuse the record unless you want them to refer to, but the notes were renewed as the stipulated facts show to 1948. Could you tell the Court what happened with regard to these notes from 1948 to 1951, if you recall? Were new notes issued? A. Yes.

Q. During these years? A. Well——

Q. (Interrupting) 1948 to 1951?

A. It's hard for me to remember without looking

(Testimony of John K. McPhearson.)

at the notes because in some years new notes were issued and in some years the notes were renewed.

Q. Well, the stipulated facts show that we only have notes up to '48, and that from 1951, or to '50, there is a gap and I wondered if you could testify as to whether you knew, whether you know the notes were issued then. If you can't, that is fine.

A. Yes, there were notes in evidence at that time. [25]

Q. Did you make a search for those notes?

A. Yes, I did.

Q. And you made a search for the earlier notes, too, the ones issued from '43 on? A. Yes.

Q. You heard your father's testimony that those had been destroyed by a flood, the earlier notes?

A. Yes.

Q. Did you subsequently make a search for the notes? A. Yes.

Q. Is that what you found?

A. Yes, that is what I found.

Q. I just wanted to clear that up because in the deposition there is some question. Now, with regard to the note issued in '51, which is in evidence, was that the notes from '51 to '55, were new notes issued each year? A. No, not during that time.

Q. How were these handled?

A. Well, the notes were left in the possession of the noteholder, to the best of my knowledge, and they were merely noted as being renewed at that time and on each of those years the noteholder, par-

(Testimony of John K. McPhearson.)

ticularly in my own case, I received a cash interest payment.

Q. Now, again the years '51 to '55, where were the notes kept, do you know? [26]

A. Well, the note that I held was kept in my belongings in the vault of the State Bank of Wilbur.

Q. Do you know of your own knowledge whether other papers were kept there of other individuals?

A. Yes, there were other papers kept there.

Q. What was the reason for this?

A. Well, during that period of years our safety deposit box vault in the State Bank of Wilbur wasn't large enough to supply our customers so all of the papers of the officers of the bank were withdrawn from the safety deposit boxes so they would be available for the public. We in turn then put them in the bank vault.

Q. Did you testify that you had possession of your note? A. Yes.

Q. Now, you had an amount outstanding in the so-called bill payable account from 19 — well, up through the taxable years involved herein, is that correct? A. Yes.

Q. How did you characterize that amount?

A. I characterize it as a loan to the company.

Q. Why?

A. I had a note in evidence of it.

Q. Do you know the difference between a stock and a note? A. Yes.

(Testimony of John K. McPhearson.)

Q. Would you explain what you think is the difference? [27]

A. Well, a stock is a right in the residual assets of the corporation upon dissolution and in the case of the stock here of Wilbur Security it carried with it a right for dividends and a voice in the management.

Q. Now, what was your interest in the note payable account at this time, in your opinion, I mean?

A. I held a note there stating a definite sum of money payable at a definite time. Of course the thing was in writing.

Q. Was there a time, Mr. McPhearson, when you owned an amount outstanding in the note payable account but owned no stock? A. Yes.

Q. Did you participate in any of the corporate meetings or anything when you were not a stockholder? A. I did not.

Q. Why?

A. I had no voice in the management of the company.

Q. Did you prior to the time that you became a stockholder share in any corporate profits?

A. None.

Mr. Constable: Your Honor, I will object now. These matters are all problems that are in issue. The witness is testifying that he never shared in any profits of the Wilbur Security. That is the very issue, whether or not the moneys [28] he received and reported as interest were in effect dividends or

(Testimony of John K. McPhearson.)

profits coming to him from the surplus available to Wilbur Security.

Mr. Butler: Well, I think that we are not trying to say by this line of questioning that he didn't receive interest or what he received might not be eventually termed by your Honor a dividend but at a time when he had an amount outstanding in this note payable account the corporate earnings none of which were distributed to him, and I think he can testify to that. He got interest, the stipulated facts show that, but the only thing I am showing he had no stock interest and obviously he did not share in the corporate profits.

The Court: The objection is overruled.

Q. (By Mr. Butler): Were you ever requested by the company to subordinate the amount outstanding in the bill payable account to other creditors? A. No.

Q. Did you ever withdraw any amounts from the bill payable account during any of the years involved herein or prior?

A. Would you state what years you have in mind?

Q. When did you first become a holder in the—well, from 1943, up to the present time.

Q. Yes, I withdrew in 1957.

Q. In 1957? [29] A. Yes.

Q. How much did you withdraw in 1957?

A. The entire amount.

Mr. Constable: That is immaterial. I object to it on those grounds. '57 is not the year in issue here.

(Testimony of John K. McPhearson.)

Our years run up through 1953, through 1955. I submit that anything that takes place after 1955 is not material to this issue, to these years.

Mr. Butler: I think subsequent events tend to show the nature of this account, your Honor, and I think it would certainly be our position that it is material. He withdrew all his amounts in 1957. He is no longer a loaner or a lender to the corporation. He took it all out. I think there is some evidence that he is still a stockholder. I mean, I think it certainly isn't decisive. I don't mean that, but I think it has some materiality.

The Court: The objection is overruled.

Q. (By Mr. Butler): Now, only with regard to your particular notes that you had from '43, through the taxable years. You have testified that there were times when you didn't get a new note. Now, how were the renewals handled?

A. We were just notified that our note had been—I shouldn't say notified, we were requested as noteholders to renew the note and if, in my particular case, I agreed. [30]

Mr. Constable: I will object, your Honor, to that question on the grounds that first of all, I don't know who "we" is that he is referring to or I don't know who is requesting him. I think I have a best evidence objection here. I would like to see this request if there was one made. I can't tell from the question whether the request was oral or written.

Mr. Butler: The best evidence rule only applies in the case of where you are trying to take a docu-

(Testimony of John K. McPhearson.)

ment and show that that document says what it purports to say. As I see it, the man was requested by the company to renew, he so testified. He can certainly testify, he was a noteholder, he went through this and he can testify what happened and I only ask him as to his note. There is no best evidence, as I see there is no document in here that we are trying to prove.

The Court: The objection is overruled.

I would suggest that counsel will clear up any ambiguity in the answer as to the "we" problems as to who he was talking about.

Mr. Butler: Yes.

Q. (By Mr. Butler): You said we were requested, or you said somebody requested you. Would you explain that to the Court just what happened?

A. The board of directors would request us or their [31] representative.

Q. Now, you testified that when you received—became a stockholder in the company—what year was that?

A. I became a stockholder in 1939.

Q. Did you at that time also get \$800 a share of the whole special account at that time? Did an amount from the special account also go over to your name by virtue of your becoming a stockholder?

A. I deposited some money in the company or lent them, I should say, in 1939.

Q. Did you know as an officer or stockholder or

(Testimony of John K. McPhearson.)

director of the company that the by-laws provided for a transfer of \$800 a share, \$800 out of the original two hundred thousand with each share of stock?

A. I didn't know it until the Internal Revenue Department pointed it out to us.

Q. When was that?

A. When they made the first examination, I believe sometime in 1956.

Q. Prior to that was this provision adhered to?

A. Not on my behalf.

Q. Now, the stipulated facts show that over the period of years when you yourself had an amount outstanding in the note payable account the notes provided, the minutes provided variable interest rate, is that correct? Some years it was three [32] per cent, some years four or five, is that correct?

A. Yes.

Q. How would that come about, would you explain that?

A. Well, interest is the price of money and I would say that was the amount that was agreed upon by the lenders and the borrowers to secure these funds for the company.

Q. Are you as a banker familiar with interest rates? A. Generally so.

Q. And how long have you been in the banking business? A. Since 1939.

Q. Were the interest rates provided for by the Wilbur Security Company and payable on the note

(Testimony of John K. McPhearson.)

on the bill payable account in your opinion excessive? A. They were not.

Mr. Butler: Now I'd like to withdraw for the purposes of examination Exhibit 27-BB, I am sorry.

Q. (By Mr. Butler): I show you, Mr. McPhearson, Exhibit 28-BB, and would you briefly describe what it is. Can you identify it?

A. Yes, I can identify it.

Q. What is it?

A. It is a letter addressed to myself as president, from the National Bank of Commerce.

Q. The date of the letter?

A. December 11, 1956. [33]

Q. Just in your own words.

Mr. Butler: I am not characterizing, George, I just want his Honor to know.

Q. (By Mr. Butler): What does it provide in substance?

A. It provides that on behalf of the Wilbur Security Company I made an application of a loan from the National Bank of Commerce from Seattle in the amount of five hundred fifty thousand for the period of one year.

Q. And what was the interest?

A. They gave an affirmative answer to this. They said they would loan this amount and at an interest rate of four and a half per cent.

Q. Did the bank take any action as a result of this letter, I mean the Security Company take any action as a result of this letter?

(Testimony of John K. McPhearson.)

A. Yes, they did.

Q. What was the action taken?

A. They used it to determine the interest rate on the amount of money they borrowed and subsequently the interest rate to our present noteholders was reduced.

Q. Did you say the interest was reduced? Would you explain that, please, for the purposes of the record?

A. As I recall, in 1956, the notes that the Wilbur Security Company had outstanding bore six per cent. Following [34] that time we reduced the—when we renewed them on the current first of the year, we reduced that to five per cent. We gave a slight bit more interest because we felt that we could borrow for a longer time from our present noteholders than we could from the bank.

Q. Now, Mr. McPhearson, you have testified, I am not leading you, I just wanted to reiterate here for the purposes of saving time, you were a director, a stockholder, and up until recent times, a noteholder in Wilbur Security Company. Did you attend during the years '52, '3, '4, and '5, the meetings of that company?

A. Yes.

Q. Were any of the non-stockholders who also had amounts outstanding in the note payable account present at those meetings?

A. They were not.

Q. Did they have anything to say about the management of the business?

A. They did not.

(Testimony of John K. McPhearson.)

Q. Did they share in the profits other than your interest payment? A. No.

Q. Now, again on your own account, you have been a noteholder, has your stock fluctuated over the years in value, in your opinion? [35]

A. In my opinion it has.

Q. Did that in any way affect your note payable holdings? A. No.

Q. Who were the stockholders in the Wilbur State Bank in 1953, 1954, and '55?

A. The stockholders were E. H. Olswalt, Godfrey Thompson, and J. McPhearson, and Mrs. Grace Phillips, and myself, John K. McPhearson.

Q. Were those individuals also the officers of the Wilbur State Bank during these years? Who were the officers of the Wilbur State Bank?

A. The officers of the Wilbur State Bank during these years were E. H. Olswalt, Godfrey Thompson, J. McPhearson.

Q. Their position, I mean I want you to say that.

A. E. H. Olswalt was assistant cashier at the bank. Godfrey Thompson was the cashier, and J. McPhearson was the president, and I, John K. McPhearson, was the vice-president. There were also other officers however at the bank.

Q. Well, who were the officers of the taxpayer corporation during the years '53, '54, and '55? We neglected to stipulate that.

A. The officers were G. Thompson was secre-

(Testimony of John K. McPhearson.)

tary, and I, John K. McPhearson, was vice-president, and J. McPhearson was president.

Q. Who were the directors, Mr. McPhearson, during the [36] years '53, '54, and '55?

A. The directors were those listed plus E. H. Olswalt and Mrs. Grace Phillips, if my memory serves me right.

Q. How were the interest payments on the note payable, on your note payable account, the interest paid in '53, '4, and '5, how was that handled, do you know?

A. Yes.

Q. Would you explain that?

A. It was deposited to my checking account in the State Bank of Wilbur.

Q. In the State Bank of Wilbur? A. Yes.

Q. Of the people who appear in the Wilbur Security Company in the exhibits that we have attached and you are familiar, I am sure, with them, how many are now alive of the original founders of the Wilbur Security Company?

A. Just two.

Q. And who are they?

A. They would be J. McPhearson, my father, and E. H. Olswalt.

Q. Now, in the stipulated facts it shows that in, I believe, 1952, or '51, the notes were issued providing for six per cent—no, five per cent and then in November of '52 the stipulated minutes show that that rate was changed. Now, were you present at the meeting when it was decided to change the [37] interest?

A. Yes.

(Testimony of John K. McPhearson.)

Q. What transpired, would you tell the Court?

A. Well, it was felt by the——

Mr. Constable (interrupting): Objection, your Honor. The minutes will show what transpired at the meeting.

Mr. Butler: I think the minutes don't show any of the discussions that went on and since he was there and also a member of the company, I think he can testify as to what transpired. There were some decisions made that just don't appear in the minutes. Obviously it isn't customary that the minutes are particularly voluminous on things of this nature.

The Court: The minutes have been stipulated?

Mr. Butler: That is correct, your Honor, and the notes show that there has been a change of interest made.

The Court: The objection is overruled.

Q. (By Mr. Butler): Would you answer that, Mr. McPhearson?

A. The meat of the discussion at that time, as my memory serves me, the interest rate seemed low to the directors of the Wilbur Security Company and they felt that they didn't want any of those noteholders to withdraw their funds and that was graded as an added incentive for them to renew those notes when they became due at the end of that year.

Q. Who made the endorsement on the back of the notes [38] when the interest was paid or who

(Testimony of John K. McPhearson.)

made the endorsement on your note when the interest was paid?

A. The note would be in my possession and if I made any I made them on my particular note.

Q. Is that customary in the banking business?

A. Yes, the noteholder would necessarily have to make his own endorsements because he has possession of the note.

Mr. Butler: I have no further questions.

The Court: Off the record.

(Discussion off the record.)

The Court: Back on the record.

The Court will stand in recess for five minutes.

(Short recess.)

The Court: The Court will come to order, please.

Cross Examination

Q. (By Mr. Constable): Will you just state again, Mr. McPhearson, what your full name is?

A. John K. McPhearson.

Q. J. K.? A. Yes, J. K.

Q. You were president of Wilbur Security Corporation what years?

A. I became president in 1956.

Q. You became president? [39]

A. I was vice-president; I became vice-president in 1940.

Q. 1940? A. Yes.

Q. During that time you were working with the affairs of Wilbur Security, were you not?

(Testimony of John K. McPhearson.)

A. Yes, except for the war years in which I was in the navy. I was absent at that time.

Q. At the same time were you working for the State Bank of Wilbur? A. Yes.

Q. You had two jobs? A. Yes.

Q. What did you do as far as Wilbur Security is concerned, what were your duties during 1940 through 1955?

A. Well, in the—that is hard to answer because they changed as those years went along.

Q. Did you spend ten, twenty per cent of your time with Wilbur Security?

A. I would say as far as day-to-day business was concerned, approximately ten per cent of my time.

Q. Did anyone spend more than ten per cent of their time with Wilbur Security?

A. Yes, I would say Mr. Thompson.

Q. I see. You, being a vice-president, you were quite familiar with its affairs, were you not? [40]

A. Yes, as familiar as you can be and only do part of the work.

Q. Well, Mr. Thompson was the only person you would say was really more familiar than yourself?

A. Yes, and my father probably was more familiar than I was. Especially in the earlier years.

Q. Did you have occasion to handle the books of account of Wilbur Security?

A. No; Mr. Thompson handled all those.

Q. You recall that you testified as to a note payable account. Do you recall your testimony to Mr. Butler in connection with a note payable account?

(Testimony of John K. McPhearson.)

A. No, I don't.

Q. Well, how, do you know in what account on the books the amounts evidenced by your notes were carried?

A. They were carried in the notes payable—what year are you speaking of now?

Q. Let's take the year 1953.

A. They were carried as notes payable.

Q. What was the name of the account?

A. Notes payable.

Q. The notes payable account?

A. Let's see. The reason it is a little confusing we changed the nomenclature of that a little later. Bills payable, I think they called it. [41]

Q. I see. When did you change it from notes payable to bills payable?

A. We redid the books in 1956, and I think we changed the nomenclature there to a, let's say a more modern nomenclature.

Q. I see. The designation of the account, then, was really rather unimportant?

A. Yes, I would say so.

Q. It didn't mean anything?

A. Well, it served as identification.

Q. When you were a noteholder and the end of the year came along, say, the end of the year 1953, what was the procedure, now, for renewing your note?

A. In that particular year, if I remember right, I as a noteholder would usually be asked by Mr. Thompson, who represented the company, and of

(Testimony of John K. McPhearson.)

course I was also present at the board of directors' meeting, asking if we would, if I would, particularly in my case, renew my note at the end of the year.

Q. There was never any doubt but what you would?

A. Well, there wasn't any doubt in my mind.

Q. Did anyone ever tell you that they had any doubts about renewing their note?

A. In what year?

Q. 1953, '4 or '5.

A. No, they didn't tell me. [42]

Q. It was more or less automatic?

A. Well, I am a little at a loss at what you call automatic.

Q. You heard your father's testimony, didn't you, Mr. McPhearson? A. Yes.

Q. I think he testified to the effect that the notes were renewed rather automatically. Would you consider that a fair statement of the facts?

A. I would say that we assumed that they would be.

Q. Did you take your note with you to that meeting?

Mr. Butler: Would counsel clarify the question to what meeting.

Q. (By Mr. Constable): To the meeting concerning the 1953 renewal. A. No.

Q. Were any of the notes present at that time?

A. You must keep in mind that the meeting was held at the State Bank of Wilbur and the office

(Testimony of John K. McPhearson.)

wasn't 20 feet from the vault in which I kept my note. There was little purpose in taking it 20 feet out to the desk and holding it and taking it back.

Q. When you kept it in the vault the other notes were kept with it, were they not?

A. Not in the year 1953. I had the note in my possession [43] in my own belongings.

Q. You had a section of the box for yourself?

A. Well, it is a little embarrassing. I had a box, a cardboard box, to be exact.

Q. When you renewed the note did you take it to Mr. Thompson?

A. Not in the year 1953, I didn't. I retained possession of it.

Q. All they did was simply pay you interest on it? A. They did.

Q. Was that a check?

A. No, it was merely a debit slip was put on the Wilbur Security Company account and the amount representing that debit slip or my interest on the note was then put on my checking account.

Q. I see. It was a book entry more or less?

A. Yes, but I did receive the money on my checking account.

Q. You spoke about a request that was made in connection with renewal of the notes. Was that a written request? A. No.

Q. It was verbal? A. Yes.

Q. To your knowledge had there ever been—

A. (Interrupting) You are speaking of the request to me?

(Testimony of John K. McPhearson.)

Q. Yes. [44] A. Yes.

Q. To your knowledge had there ever been a written request made in any year?

A. I couldn't testify to that.

Q. Had there ever been a written request made to you? A. No.

Q. As the vice-president of Wilbur Security you didn't know in any of the years from 1940 through 1955 whether or not a written request had been made in the case of the renewal of any notes?

A. I wouldn't know of it, no.

Q. As a matter of fact, Mr. McPherson, the requests are customarily made verbally at these meetings, are they not? A. Yes.

Q. Is there usually much negotiating taking place during the renewal of the notes at the meetings?

A. I am afraid I don't understand what you mean.

Q. Does Wilbur Security bargain with the note-holders? A. You mean on a bidding basis?

Q. Are there any discussions, negotiations leading up to the renewal of the note?

A. Not any more than would be between a customer and a banker, for instance.

Q. What type of negotiations take place, are there usually arguments? [45] A. No.

Q. Have you ever made any loans to anyone other than Wilbur Security for large, unsecured amounts of money? A. Yes.

Q. To whom were they made?

(Testimony of John K. McPhearson.)

A. In what year? I have a number of them outstanding.

Q. In the year 1952.

Q. Yes, I had a note out to a firm called O'Brien Brothers that is my own personal money. I think the amount at that time was in the approximation of \$30,000.

Q. Is this customary in the conduct of your affairs that you loan money on a promissory note without any security?

A. Depends on the man's financial statement.

Q. Does it depend on how well you know the man to whom you are loaning the money?

A. That would be an important element.

Q. It would depend to a great extent on your relations with him, would it not?

A. It always does.

Q. Do you know who the officers of Wilbur Security were from 1940 through 1952?

A. Let's see, 1940. Well, if you had stated from '41 through that time I could remember.

Q. All right, from '41 through '52?

A. It would have been J. McPhearson was president, I, [46] J. K. McPhearson, was vice-president, and Godfrey Thompson was the secretary.

Q. And do you know who the directors or trustees of Wilbur Security were for the period of '41 through '52?

A. I am relying entirely on memory. I think the stipulations would bear that out.

(Testimony of John K. McPhearson.)

Q. I would like to know what your memory is on that point.

A. Yes, if my memory is right, the board of directors consisted of Mrs. Grace Phillips, who was known at that time as Mrs. Grace Fisk, and E. H. Olswalt, and Godfrey Thompson, and myself, J. K. McPhearson, and J. McPhearson. Or did I name him before, I forgot, J. McPhearson.

Q. What year did your mother pass away?

A. 1953.

Q. At the time that she died was she a noteholder? A. Yes.

Q. Do you recall during the period following her death where you located her note?

A. It was in the estate papers of that, of that estate, and I was the executor.

Q. Where was the note when you found it?

A. It was in the possession of my father with his other papers.

Mr. Butler: Could counsel clarify that? I don't [47] think the witness understands. Do you mean, counsel, where it was when they went to look for it, is that what you mean?

Mr. Constable: I asked Mr. McPhearson where he had found the note. As I understand, he was executor and he said it was with his father.

Q. (By Mr. Constable): Referring to Exhibit 28-BB, had Wilbur Security ever requested a loan from anyone other than the Farnsworth and McPhearson family similar to that request shown on 28-BB?

(Testimony of John K. McPhearson.)

A. Would you state that again, please?

Q. Well, you testified that this was a, this letter consisted of a loan to be made by the National Bank of Commerce to Wilbur Security Company, did you not?

A. Yes.

Q. And Wilbur Security Company made that request, did they not?

A. Yes. I made it on behalf of Wilbur Security Company.

Q. Had you ever, prior to 1956, made a similar request on behalf of Wilbur Security Company to other than the Farnsworth or McPhearson family?

A. That is very confusing because there were other noteholders other than the Farnsworth and McPhearson families.

Q. Did you ever make a request to a banking organization?

A. I did not, but one was made and is in the minutes.

Q. Did the Wilbur Security Company ever inquire whether [48] or not they could borrow money cheaper than they were borrowing it from their present noteholders, say, during the year 1953?

A. I don't believe they did, no.

Redirect Examination

Q. (By Mr. Butler): Is borrowing money cheaper the thing you look to when you are getting a loan?

A. No, sir.

Q. What are the other considerations?

(Testimony of John K. McPhearson.)

A. It is hard for me to say, I am usually on the other side of the table. I am theorizing in my case as to how I would feel in loaning the money and then, on the other hand, as the borrower and representative of Wilbur Security Company. I would say that the prospect of renewal is important.

Q. Did you testify that you had independent knowledge of a prior loan that was, that you tried to get a prior loan?

A. I read in the minutes at one time that they had tried to get a loan from, I think then Fidelity.

Q. You can't testify, then, from your own knowledge about that loan?

A. I can only testify as to what I saw in the minutes.

Mr. Butler: I withdraw the question then.

Q. (By Mr. Butler): Mr. Constable asked you about Wilbur Security and how [49] much of your time was spent. Was there, in fact, a great deal to do with regard to the business of Wilbur Security? A. No.

Q. Now, you testified about the nomenclature of this account and I just want to clear the record up. Did you say that the account was originally known as the bills payable account?

A. In what year?

Q. From 1943 to 1956. A. Yes.

Q. And then it was changed? A. Yes.

(Testimony of John K. McPhearson.)

Q. What was it changed to?

A. Notes payable.

Q. Would you tell the Court just a little bit—first of all, how big is Wilbur?

A. There is about 1,100 people there.

Q. The record will show that. Do you carry on business, the banking business, similar to the way, exactly the way it is done in the bigger cities?

A. No, it on a more personal basis.

Q. Do you know most of the people you do business with? A. Yes.

Q. Mr. Constable asked you if there were any great arguments that took place with regard to bargaining with renewal [50] of these notes and I ask you do you have any great arguments with anybody in the banking business? A. No.

Q. Now, I just wanted to clear one other thing up. You said, and I wasn't sure you understood, Mr. Constable asked you where you found your mother's note, and what was your answer again?

A. I found it in papers belonging to my father.

Q. Was that when you were looking for it? What I am trying to clear up is you were executor of the estate? A. Yes.

Q. And you gathered the assets? A. Yes.

Q. Where did you find the note?

A. My father brought out all the papers belonging to the family and we found it in that portfolio.

(Testimony of John K. McPhearson.)

I might point out that that was just one of many notes.

Mr. Butler: I have no further questions.

Mr. Constable: I have just one matter, your Honor.

Recross Examination

Q. (By Mr. Constable): You testified, Mr. McPhearson, that regarding this procedure upon renewing of the notes that we were requested. I take it you were referring to the noteholders, isn't that correct? [51] A. Yes.

Q. Now, you knew, of course, that all the other noteholders, that a similar request was made to all the other noteholders, did you not?

A. No, I couldn't testify to that unless I made the request myself and it would depend then on what year you are referring to.

Q. In what year did you make the requests?

A. It would be from 1956 on.

Q. I see.

Mr. Constable: That is all I have.

Mr. Butler: That is all.

The Court: The witness is excused.

(Witness excused.)

Mr. Butler: I would call Mr. Campion to the stand, please.

Whereupon,

MORRILL W. CAMPION

called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

The Clerk: Take the stand. State your name and address, please.

The Witness: Morrill W. Campion. I live at 1104 East Thirty-seventh, Spokane. [52]

Direct Examination

Q. (By Mr. Butler): What is your occupation?

A. I am an appraiser.

Q. Would you give the Court the benefit of your experience, reiterating your experience in the appraising business?

A. Well, I graduated from the University of Minnesota, the College of Agriculture, with a degree as a Bachelor of Science in agriculture in 1926. I spent a few years in the livestock industry and in 1933 I became employed by the Federal Land Bank of St. Paul as an appraiser. I appraised for the Land Bank in 1937, at which time I became employed by the Equitable Life Assurance Society of The United States. I appraised farms in the Midwest until 1947, at which time I was transferred to the Pacific Coast and appraised farms west of the Cascades until 19—January 1952, at which time I was transferred to Spokane and have been appraising farms in Eastern Washington and Northern Idaho and part of Oregon since that time.

(Testimony of Morrill W. Campion.)

Q. Have you done any appraisal work in and around the Wilbur, Washington, area?

A. Yes, I have.

Mr. Butler: I would request of the Court to withdraw Exhibit 27-AA, which is a list of the farms owned by the Wilbur Security Company during the years involved herein. [53]

Q. (By Mr. Butler): I show you this list, Mr. Campion, and ask you if at our request—if you have seen this property—are you familiar with that list. A. Yes, I am.

Q. And what is it, Mr. Campion?

A. It is a list of the farm holdings of the Wilbur Securities Company.

Q. Have you seen all of this property?

A. I have.

Q. And when was the last time that you looked at it? A. Last Thursday.

Q. And have you at our request formed an opinion as to the fair-market value of these properties in the years at the beginning of 1953, the end of '52, and the years '53 and '4 and '5?

Mr. Butler: I withdraw the question. I am afraid I have confused you.

Q. (By Mr. Butler): Have you at our request gone over this property with the idea of appraising it, its fair market value in 1953, '54, and '55?

A. I have.

Q. Have you formed such an opinion?

A. I have.

(Testimony of Morrill W. Champion.)

Q. What in your opinion is a fair market value of the [54] farms during the years I mentioned?

A. My appraisal as of January 1, 1953, is \$1,610,000. The fair-market value for '54 and '55 would be just in excess of that amount.

Q. Now, just briefly would you care to comment on the basis of your opinion?

A. My appraisal was based on comparison of known sales of similar properties in the community, the income, anticipated income during that period of time, anticipated income to the landlord during that period of time.

Q. Did you check the income to the landlords during that time? A. I did.

Q. Or to the farm owners or to the farm renters, I should say?

A. Not to the renters; to the landlord.

Q. I see. Now, you are in the farm loan business, is that correct? A. That is right.

Q. And you, on the basis—what exactly is your job after you have appraised a farm?

A. I appraise a farm for loan purposes for the Equitable Life and make my recommendation and service the loans after they're made.

Q. Now, based on your appraisal of this property, would [55] you have recommended a loan in excess of \$5,000 of the Wilbur Security Company to your company?

A. Five hundred thousand?

Q. Five hundred thousand.

A. Yes, I would have.

(Testimony of Morrill W. Campion.)

Q. What would that be based on?

A. It is based on the market value of the farms, the credit risk involved, the anticipated income.

Mr. Butler: I have no further questions, your Honor.

Mr. Constable: No questions, your Honor.

The Court: The witness is excused.

(Witness excused.)

Mr. Butler: Could I beg your indulgence for just a second. I think we can save time.

The Court: Go ahead.

Mr. Butler: I would call Mr. Larry Morse to the stand, please.

Whereupon,

LAURENCE D. MORSE

called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

The Clerk: Take the stand and state your name and address for the record, please.

The Witness: My name is Laurence D. Morse. My address is 911 West Thirty-second, Spokane, Washington. [56]

Direct Examination

Q. (By Mr. Butler): You stated your name and address. Would you state your occupation?

A. Certified public accountant.

Q. How long have you been in that field?

(Testimony of Laurence D. Morse.)

A. Since 1946.

Q. During the taxable years '53, '54, and '55, were you the certified public accountant for the Wilbur Security Company? A. I was.

Q. Did you prepare the tax returns?

A. I did.

Q. When did you first take over this account, that is, by yourself?

A. In the tax season of 1953.

Q. Now, would you explain how that came about, if you would?

A. My partner, Mr. R. J. Wortman, had been the certified public accountant for the Wilbur Security Company for a number of years. He passed away on March 15, 1952, and I was retained by the Wilbur Security Company to prepare the tax returns.

Q. Now, have you at our request reviewed the books and records of the Wilbur Security Company with regard to the [57] entries made on the fourteen thousand item? A. I have.

Q. I see.

Mr. Butler: Might I withdraw Exhibit 150 (a)?

Q. (By Mr. Butler): I show you Exhibit 150 (a), which are the stipulated minutes of the Wilbur Security Company. I call your attention to the fact that the bills payable in the estate of Sarah A. Farnsworth was reduced in the amount of \$14,000. Have you checked the books to ascertain how that transaction was handled on the books and records of the Wilbur Security Company?

(Testimony of Laurence D. Morse.)

A. Yes, I have.

Q. Have you made a summary from those books and records for your own purposes of testifying?

A. Yes, I have.

Q. Would you tell the Court, Mr. Morse, please, what the books show, the entries in the books show concerning that \$14,000?

A. On January 1, 1953, the books show the following entry: "Sarah A. Farnsworth special account debit 17,000, credit bank 17,000."

On the same day these following two entries were reflected on the books, a debit to the bank of 1,000, a credit to the Sarah A. Farnsworth special account 1,000, a debit to the bank of 2,000, and a credit to the Sarah A. Farnsworth special [58] account of 2,000. This in effect reflects the disbursement in cash to the Sarah A. Farnsworth estate in the net amount of 14,000.

On January 4, 1954, the following entry was made in the books: A debit to the bank of 3,000, and a credit to the Sarah A. Farnsworth special account of 3,000. A debit to the bank of 5,000, and a credit to the Sarah A. Farnsworth special account 5,000.

On January 12, 1954, a debit to the bank of 6,000, and a credit to the Sarah A. Farnsworth special account of 6,000.

The effect of this is that \$14,000 was received by the Wilbur Security Company, deposited and credited to the Sarah A. Farnsworth special account.

Q. Now, was any interest credited on the books

(Testimony of Laurence D. Morse.)

of the Wilbur Security Company when that amount was repaid?

A. There was no disbursement or entry indicating that an interest payment had been made on this fourteen-thousand disbursement.

Q. Are the records of the corporation consistent with the direction in the minutes?

A. By and large they are consistent with the minutes. However, if I were Mr. Godfrey making the entry that was set forth here in the minutes of this meeting, I would have done it just a little different. [59]

Q. Good accounting principles would dictate that you follow what in making an entry such as this?

A. You follow the minutes, the minutes are controlling.

Q. Would you explain just briefly the control account that was involved?

Mr. Butler: I withdraw the question.

Q. (By Mr. Butler): We have talked briefly—I have here an account taken from the books and records of the Wilbur Security Company and ask you if you can identify it.

A. Yes, that is a general ledger page entitled “Notes Payable”.

Q. Where is this taken from?

A. That’s been taken from their most current general ledger.

Q. What years would that involve?

A. This involves the years 1956 and ’57.

Mr. Butler: I offer this in evidence at this time.

(Testimony of Laurence D. Morse.)

Mr. Constable: Objected to on the grounds of materiality.

The Court: For what purpose?

Mr. Butler: I wanted to clarify this account has been changed from bills payable to notes payable. This was made by the accountant of the company for purposes of his own. The account shows the amount outstanding in the bills payable [60] account in 1956, and 1957, and I say that these amounts have changed. Mr. McPhearson has testified that he is no longer, 1957 is no longer, a holder of any amount outstanding in the bill payable account, although it's subsequent years, I think it lends some credence to the position taken by the petitioner herein.

The Court: You quoted some examples at the time when I overruled respondent's objection on the year 1957. I have serious consideration of years not here in issue and particularly putting the books and records in.

Mr. Butler: This is everything in the note payable account up to 1956 is the subject of Joint Exhibit 14-N. This just carries on and explains these later years and also this note payable change and I would again offer it in evidence, your Honor.

The Court: The objection is overruled. It will be received.

The Clerk: Petitioner's Exhibit 44 is received in evidence.

(Petitioner's Exhibit No. 44 was received in evidence.)

(Testimony of Laurence D. Morse.)

Q. (By Mr. Butler): Exhibit 44 contains the heading "Notes Payable". Who made that change?

A. I did. [61]

Q. You changed it from bills payable to notes payable. And what was the purpose of the change?

A. When Mr. Godfrey passed away the Wilbur Security Company asked that I revise **their accounting** system somewhat and at that time I dropped the nomenclature of bills payable in that it is seldom used any more, being a very old-fashioned term, and used the terminology notes payable.

Mr. Butler: Could I withdraw Exhibit 14-N for the purpose of—I am sorry to take the Court's time, but this is something Mr. Constable wants and I want to get it in.

Q. (By Mr. Butler): I show you what has been identified and stipulated as Exhibit 14-N and ask if you are familiar with that exhibit.

A. Yes.

Q. That is the bills payable account. And I ask if you have you examined some of the journal entries concerning that account.

A. Yes, I have.

Q. And how was this account handled on the journal, the journal entries?

A. As an example we will take the end of the year 1943. At that time the bills payable account was debited for the amount of the note and the bank was credited indicating that the note was paid. Then on the first of the next year, which would be January 1 of 1944, the accounts bill payable was [62] credited and the bank was debited in-

(Testimony of Laurence D. Morse.)

dicating that another note was negotiated and a loan made.

Q. Did you at our request search the books with regard to the year ending 12/31/1942?

A. Yes.

Q. What was the book value of the farms owned by the Wilbur Security Company at that time?

A. It was approximately four hundred thousand.

Mr. Butler: I have no further questions.

Cross Examination

Q. (By Mr. Constable): Referring to Exhibit 14-N and to the year 1943, and the journal entries which you testified to, is the journal for that year in court?

A. Yes, sir.

Q. Referring to your testimony in connection with the check, the entries in 1943, where the notes were paid and the accounts payable account was debited and the bank was credited and on the opening of the next year that the bank was debited and the accounts payable credited, those were strictly book entries, were they not?

A. That is correct. However, the word "bank" is, I believe, well, see, in referring to this journal entry is set forth. Furthermore, I think it uses the term "cash" in there also, but it is a book entry.

Q. No cash changed hands nor were checks drawn in connection with the entries?

A. I don't believe there were. If you will refer to page 87.

(Testimony of Laurence D. Morse.)

Mr. Constable: I have no further questions, your Honor.

Mr. Butler: Is it all right if we leave Mr. Morse on the stand until we get finished with this other question here?

I would return at this time the exhibits withdrawn.

Mr. Constable: Your Honor, referring to the stipulation of facts that has been filed, due to certain difficulties in the mechanics of putting it together we found it necessary to omit paragraph 26 from the stipulation of facts. There will be no paragraph 26. Now, we had an exhibit marked for that paragraph. At the present time there is no Exhibit 23-W included in the stipulation of facts, that is a vacant exhibit number, and I would like to have this marked, this piece of paper marked as Joint Exhibit 23-W.

Would you mark it, Mr. Clerk.

Mr. Constable: Your Honor, in connection with——

The Clerk: Joint Exhibit 23-W is marked for identification.

(Petitioner-Respondent Exhibit No. 23-W was marked for identification.) [64]

Mr. Constable: Respondent offers to stipulate that the column headings on Joint Exhibit 23-W are correctly stated. Also that for the years 1915 through 1936 no interest was paid on the \$200,000 described in the special stockholders' account.

Respondent further offers to stipulate that during the years 1932 through 1936 no amounts of interest

(Testimony of Laurence D. Morse.)

were accrued on the books with regard to interest payments in connection with the special account and bills payable account.

Mr. Butler: I so stipulate, your Honor.

Mr. Constable: I will then offer Joint Exhibit 23-W.

Mr. Butler: No objection, your Honor.

The Court: It will be received.

Mr. Butler: Could I withdraw it for just a second?

The Clerk: Joint Exhibit No. 23-W is received in evidence.

(Petitioner-Respondent Exhibit No. 23-W was received in evidence.)

Redirect Examination

Q. (By Mr. Butler): I show you what has been offered in evidence as 23-W and ask you if the amounts of interest paid here from 1915 to 1936—we have stipulated that no interest has been paid on the \$200,000 in the special stockholders' account. Were there dividends paid on the \$200,000 during those years? [65]

A. No, sir, not on the special stockholders' account.

Mr. Constable: Objection, your Honor, but I think we understand——

Mr. Butler: I don't mean to characterize it as——

Mr. Constable: I will withdraw the objection.

Mr. Butler: Now, there is just one other small thing, your Honor. Mr. Constable requested that we supply him with some minutes. The minutes

(Testimony of Laurence D. Morse.)

are old minutes from the years back in the '30's and '40's. They're in a permanent minute book. Could we offer at this time the minute book and we will withdraw it and provide the Court and Mr. Constable copies of the minutes in photostat. I don't know how we will do it.

Mr. Constable: If you have found that these minutes exist I will read into the record of the four minutes I want and we will stipulate that these are the minutes I want.

The Court: I think that is definitely the thing to do.

Mr. Constable: I am now referring to the minutes of Wilbur Security Company for four meetings, first, of December 31, 1931, second of December 30, 1940, the third of December 30, 1941, and the fourth, of December 30, 1942. I will offer those, I will offer to stipulate with Mr. Butler that those may be put into evidence after we are able to make copies of them from the minute book.

Mr. Butler: Are those the directors meetings or [66] stockholders meetings?

Mr. Constable: I believe they're called either directors or trustees.

Mr. Butler: We can stipulate that if the minutes are there we will certainly give them to you.

We so stipulate, your Honor.

The Court: The Court understands that it is not definite that these minutes are in existence.

Mr. Butler: Apparently there is some question about the first one that he requested, but if we can

(Testimony of Laurence D. Morse.)

find it, if it is there we will let Mr. Constable go through the record and——

Mr. Constable: Your Honor, I——

The Court: The Court might make this suggestion that rather than receive into evidence something which is not clearly in existence that the Court would be glad to keep the record open for a period of, say, 30 days, during which you could prepare a stipulation on these minutes if they are located.

Mr. Constable: That would accommodate the respondent, your Honor.

The Clerk: As a supplemental stipulation?

The Court: Supplemental stipulation.

Would that be agreeable to both parties?

Mr. Butler: Yes, your Honor, we will be back Thursday on another case and we will try to bring them at that time. [67]

Mr. Butler: That concludes the petitioner's case, your Honor.

Mr. Constable: That is all I have, your Honor.

The Court: The witness is excused.

(Witness excused.)

The Court: Both parties rest?

Mr. Butler: Yes, your Honor.

Mr. Constable: Respondent rests, your Honor.

The Court: Mr. Constable, how many days for brief? I am addressing you because I think you are the burdened party as far as briefs are concerned at this time.

Mr. Constable: I wonder, your Honor, if I could have 60 days perhaps on it, say, 60 and 30.

Mr. Butler: Anything that is convenient for Mr. Constable is fine. We would prefer to get it out sooner than that but whatever Mr. Constable and the Court decide is fine.

The Court: I would rather make it 45, it seems you could do it, it is easier to do it and be lenient if you can't. Sixty days and thirty days would mean that I couldn't reach this case until July sometime. And I would prefer 45. I think I could get to it in June, if we got the brief in in 45 days. If you cannot do it, of course you can request an extension.

Mr. Constable: I am quite familiar with that procedure, your Honor. [68]

The Court: So is the Court.

Simultaneous briefs in 45 days, answer 30 days thereafter. The record will also remain open for 30 days from today for submission of a supplemental stipulation of facts covering the minutes of those four directors meetings. Of course if the stipulation can be filed prior to that time the Court would be glad to receive it.

Mr. Butler: We will try to get it here by Thursday, your Honor, if we can.

The Court: Will you announce the dates, Mr. Clerk.

The Clerk: The opening dates due May 1, 1958, and reply briefs May 31, 1958.

The Court: The case stands submitted.

The Court stands in recess until 10 o'clock tomorrow morning.

(Thereupon, at 5:20 o'clock, p.m., Monday, March 17, 1958, the hearing was closed.) [69]

[Endorsed]: T.C.U.S. Filed April 11, 1958.

The Tax Court of the United States

Docket No. 68,408

WILBUR SECURITY COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DEPOSITIONS OF GRACE LEWIS PHILLIPS
AND JOHN McPHERSON

Be It Remembered that on the 8th day of November, 1957, at the hour of 10:00 o'clock, a.m., at the office of Wilford H. Payne, Assistant Regional Counsel, San Francisco Region, Internal Revenue Service, United States Court House, Seattle, Washington, pursuant to stipulation, personally appeared before me, James R. Royse, a Notary Public in and for the State of Washington, County of King, duly appointed and commissioned to administer oaths:

Grace Lewis Phillips called to testify by deposition at the instance of the petitioner;

Francis J. Butler, Esq., and Paul Castoldi, Esq., Attorneys at Law, appearing for and on behalf of

petitioner; Nelson P. Rose, Esq., Chief Counsel, Internal Revenue Service, by Wilford H. Payne, Esq., Assistant Regional [1]* Counsel, San Francisco Region, Internal Revenue Service, appearing for and on behalf of respondent;

Whereupon, the following proceedings were had and done, to-wit:

Mr. Butler: I want to say for the purpose of the record that these depositions are being taken in accordance with the stipulation to take depositions which has been filed in this case, signed by Mr. Castoldi as counsel for the petitioner and by Nelson P. Rose and Mr. Payne as representing the Chief Counsel's office, Internal Revenue Service.

Mr. Payne: Mr. Nelson P. Rose is Chief Counsel, Internal Revenue Service, and he is counsel for the Commissioner of Internal Revenue.

I think the record should also show, Mr. Butler,—I assume Mr. Castoldi and Mr. Butler are both of record?

Mr. Castoldi: That is correct.

Mr. Payne: I assume the record should show these depositions are taken by stipulation and at the expense of the petitioner, and these are petitioner's witnesses.

Mr. Butler: That is correct.

Mr. Payne: And the cost of the depositions is to be paid by the petitioner.

Mr. Butler: That is certainly correct. [2]

(Discussion off the record.)

* Page numbers appearing at bottom of page of Original Deposition.

GRACE LEWIS PHILLIPS

being first duly sworn, testified on oath as follows:

Direct Examination

Q. (By Mr. Butler): Mrs. Phillips, would you state your name for the record, please?

A. Grace Lewis Phillips.

Q. And your address?

A. 1617 Sylvester Street, Olympia, Washington.

Q. Are you the Grace Phillips who is at the present time a stockholder and a note holder in the Wilbur Security Company? A. I am.

Q. Now, we are dealing here in the Wilbur Security Company case with facts that involve the years 1915 to the present time. Would you state for the record the other names that you might be referred to by in these records of the Wilbur Security Company throughout the years?

A. Grace Lewis Farnsworth was my maiden name, and my name by my first husband was Grace Lewis Fisk, or Mrs. E. M. Fisk.

Q. The records of the Wilbur Security Company show an [3] E. L. Farnsworth as one of the original incorporators. What relation is he to you?

A. Edward Lewis Farnsworth was my father.

Q. And the records also show a Sarah A. Farnsworth. What relation was she to you?

A. She was my mother.

Q. And they are both deceased at the present time? A. They are.

Q. Now, would you please tell us when you first became aware of any Wilbur Security Company?

(Deposition of Grace Lewis Phillips.)

A. After my marriage in 1918 my father customarily sent me a simple record of accounting of what moneys I had. He handled my business for me, and he sent it so that it could be incorporated with the earnings of Mr. Fisk, my husband at that time, for income tax purposes. After his death in 1926, he turned over such moneys to me with the accounting.

Q. Now, during the years 1952, 1953 and 1954, which I might explain are the taxable years involved here, you held an account in what is termed on the books of the Wilbur Security Company as a "note payable account," is that correct?

A. That is correct.

Q. Do you know the difference between a note and a stock contribution? [3-a]

A. Yes, I do.

Q. Would you explain in your own words what you think the difference is?

A. A stock represents a share in a company for which you hold certificates, and with stock you have voting rights and you obtain dividends from the stock.

Q. Speaking now about the amount outstanding in the "note payable account" of the Wilbur Security Company, in your opinion what was the nature of that account?

Mr. Payne: I object to that question as calling for the conclusion of the witness, namely, her opin-

(Deposition of Grace Lewis Phillips.)

ion of accounts and the nature of them, as being improper.

Mr. Butler: I think I may say for the record that the crux of this particular matter is the intent of the parties involved with regard to the "note payable account," and that our position is that Mrs. Phillips can certainly give her opinion as to what she considered the nature of the "note payable account" to be.

Q. I would like to ask you again, in your opinion what was the nature of the amount outstanding in the "note payable account" of the Wilbur Security Company from 1950 to the present time?

A. Well, it represented a loan to the company. I had no voting power; I had no stock interest in the company; [4] and I received only interest; I didn't receive dividends.

Q. When was the first time, Mrs. Phillips, that you heard that the Government was contending that the amount in the "note payable account" was a stock contribution as opposed to a loan?

A. Last year—1956.

Q. Going back, if I may, to earlier years, Mrs. Phillips, and again talking about the "note payable account" or the stockholder account, or whatever it might be known as, did you ever discuss this account with your father?

A. Yes, I did.

Q. And would you kindly state the nature of that conversation?

A. Before my father's death he told me that that money was there on loan; that it was in a very

(Deposition of Grace Lewis Phillips.)

liquid form; that he had put it there so that I could withdraw it to pay inheritance taxes, and that by notifying the bank when I would need the money, or the officers of the bank when I would need that money, that it could be taken out and so used.

Q. As I understand, then, you understood that you could draw down this amount upon proper notice? A. I did.

Q. Did you cash in or draw upon this account?

A. I did.

Q. Would you explain when and why? Did you do it after 1950? A. Yes.

Q. Would you explain the nature of that?

A. When my father's inheritance tax was paid, I drew funds from that account up to the amount of \$69,000, and at the time of settling my mother's estate, I again drew on that account to the tune of \$14,000.

Q. Can you tell us how you went about drawing that \$14,000? Did you call——

A. (Interposing) I just can't remember exactly whether I telephoned or wrote Mr. McPherson or Mr. Thompson over at the bank. I mean, sometimes I telephoned and sometimes I wrote. Probably I telephoned because it was easier to keep things straight. When you talked to a person personally you can keep things straight, and I would tell them I would need certain amounts, and what time I would need them.

Q. You don't know how that transaction was handled on the books of the Wilbur Security Company? A. I didn't see the books.

(Deposition of Grace Lewis Phillips.)

Q. Now, concerning the year 1954, did you treat the amount received as interest from the Wilbur Security Company as a dividend on your income tax return? [6] A. Yes.

Q. On your tax return? Do you understand the question? A. State it again.

Q. Did you treat the interest received in 1954 as a dividend?

A. No, I didn't treat it as a dividend; I treated it as interest.

Q. You didn't take the dividends received?

A. The dividends were always credited to my mother's estate until the estate was finally settled in August, 1955.

Q. Now, would you, if you had been requested, have subordinated this amount in the loan account to other creditors?

Mr. Payne: I object to that question for the purpose of the record as calling for a possible state of mind or conclusion which this witness was never called upon to give, upon the ground that it is merely a hypothetical or contingent possibility.

Q. Do you understand the question?

A. I think I do.

Q. Would you have subordinated this amount to other creditors? A. No, I would not.

Q. Do you own a stock interest in the Wilbur Security Company? A. I do. [7]

Q. When did you acquire that stock interest?

A. I inherited it from my mother when the estate was settled in August, 1955.

(Deposition of Grace Lewis Phillips.)

Mr. Butler: I have no further questions.

Cross Examination

Q. (By Mr. Payne): Mrs. Phillips, did you inherit any stock from your father?

A. My mother had all the stock from my father's estate, and I didn't inherit any until after her death.

Q. So when you inherited your mother's interest in 1955, that really represented the interest that your father formerly had before his death?

A. His interest and her community interest, yes.

Q. And your father died before your mother?

A. He died in 1940.

Q. And your mother died in 1955?

A. In 1951.

Q. In 1951. So what stock interest did you acquire at that time, Mrs. Phillips?

A. I acquired a stock interest in both the bank and the security company, after my mother's death; I mean, after her estate was settled.

Q. Do you remember the amount of stock in Wilbur that you owned at that time? [8]

A. I am not sure, Mr. Payne. I could take a guess at it, but I am not sure; I would have to check.

Q. The records would show it?

A. Yes, I am sure they would.

Q. Mrs. Phillips, you state that you also acquired the interest that your parents had formerly owned in the bank. Will you identify that bank?

(Deposition of Grace Lewis Phillips.)

A. The State Bank of Wilbur.

Q. Do you know the extent of that stock interest which you acquired in the bank?

A. The record will show. I think I know, but I wouldn't want to give sworn testimony as to what was the number of shares without checking it.

Q. Approximately, was it a large or small percentage?

A. I think it was ninety shares, but I am not sure; I never try to remember things I can look up, which are figures.

Q. You are talking about the bank?

A. I am talking about the bank, and I think it was that, but I am not sure. You understand, I don't swear that that is the amount without checking it.

Q. I am just asking you what you know about it. You just testify what you know about it. Do you know how much outstanding stock there was in the bank at that time? [9]

A. No.

Q. Did you become an officer in the bank?

A. No.

Q. Did you become an officer in Wilbur Security Company?

A. No.

Q. Is it your understanding that the bank interest had been owned by your father simultaneously with his interest in the Wilbur Security Company?

A. May I ask you what you mean by simultaneously? I know that one is not as old as the other, so they could not be simultaneously from the beginning.

(Deposition of Grace Lewis Phillips.)

Q. Which is the older? A. The bank.

Q. And the Wilbur Security grew out of that operation, did it?

A. I don't know; I can't testify to that.

Q. You gave some testimony which I don't understand about 1926, when you had some money with your then husband, Mr. Fisk.

A. My husband, Mr. Fisk, died in 1926.

Q. And you had some money then?

A. I said,—I think what you are referring to, Mr. Payne, is the fact that after Mr. Fisk's death my father turned over what little moneys I had of my own to me for my use because my husband, Mr. Fisk, did not leave me [10] provided for.

Q. You said something about investing that money?

A. No, I didn't say anything about investing it.

Q. I beg your pardon.

A. I never had enough to invest.

Q. Mrs. Phillips, Mr. Butler asked you if you know the difference between notes and stock?

A. Yes.

Q. And you said you did. When did you acquire that knowledge?

A. I think it was as a very young girl that my father started teaching me, and I worked for a while for the Marine Bancorporation, and I had it very thoroughly pounded into my head at that time.

Q. Do you remember when you first made an advance of funds of any size to the Wilbur Security Company?

(Deposition of Grace Lewis Phillips.)

A. No, I can't tell you the exact date. My father would give me money as a young woman, and it was deposited there for me, but I can't remember the exact date. I think it was around 1918, but I am not sure.

Q. Would you be able to say where that money came from?

A. Probably as gifts from my father, or he had given me a little stock as a young girl, and he probably took the interest and made up some of it that way, but I couldn't testify with accuracy as to where it came from. [11]

Q. Do you remember now how that amount increased or decreased over the years from that time down to the present?

A. Largely from gifts from him or from interest. The interest was always just redeposited there.

Q. Did you have some other stock that you acquired in those earlier years? A. Yes.

Q. Did you have some bank stock?

A. No.

Q. Where did these stocks come from that you acquired?

A. Well, I had some from my first husband, and I had some from my own earnings, and some as gifts from my father.

Q. Which predominated?

A. Gifts from my father.

Q. Did you ever receive a note from Wilbur Security Company with respect to the moneys which you had on deposit there?

(Deposition of Grace Lewis Phillips.)

A. No, I don't think I ever did.

Q. Can you say that you had money on deposit with the company at all times since about 1918?

A. As far as I know, yes.

Q. And the amount has varied somewhat, do you think, or can you testify to that?

A. I can't testify, but I am quite sure it has varied. [12]

Q. It usually increased, is that correct?

A. So far as I know, Mr. Payne. I never drew any money from that account until it was necessary, as taking that out for inheritance tax purposes for the estate of my father and for my mother.

Q. Let me ask you this: Do you remember or do you know whether you always received some return on that deposit? You may call it interest and we may have some other term for it, but did you receive some return on that deposit in each of the years since your original deposit, or do you know?

A. I am not absolutely sure, but I think there were times,—there were bad times when there was no interest paid. I am not absolutely sure, but I think I have a recollection of my parents saying there would be no money forthcoming from Wilbur in certain years that were bad years, but I can't testify positively.

Q. What explanation did your father give you with respect to those bad years, as you call it?

A. Hard times and bad crops. I think I

(Deposition of Grace Lewis Phillips.)

shouldn't perhaps testify to that. I know there were years when there was no money.

Q. I am just asking you to testify to what you know and can remember. Can you tell us this, for the record: When you had a skip year, for example, was the amount [13] which normally should have been expected for that year made up to you at some subsequent time?

A. I would have no knowledge of that because my father handled my business in his own way.

Q. Let me ask you again about this so-called interest—and I am sure we are not limited by the meaning of terms here, because that is the purpose of this proceeding, the legal effect of them—did you receive it in cash, in check or by credits on the books, or do you know?

A. I don't know. I mean, as far as any money I actually received was concerned, my father would send me a check which included what he would give me, or what little income I had.

Q. Did you customarily get a payment, or did you customarily get a credit or notice of the amount of credit to your account?

A. I customarily got from my father at the end of the year an accounting which showed it so that it could be taken care of for income tax purposes.

Q. Mr. Butler asked you if you had discussed these matters with your father, and you said you had discussed them with him, and that he indicated to you that you could withdraw those amounts. That was just a general understanding? [14]

(Deposition of Grace Lewis Phillips.)

A. I don't know what you mean by "a general understanding." It was a pretty definite understanding by me that they were there, because he told me prior to his death that they were there for the purposes I needed them.

Q. As long as he was alive, you would work through him, would you not?

A. He always took care of everything until about two months before his death, when he knew, —he had a cancer operation, and he knew he needed to teach me, and at that time he went pretty thoroughly into business affairs with me.

Q. Did you know at that time that his financial interests were going to your mother?

A. No, I knew nothing about his will until after——

Q. Until after he died? A. No.

Q. Did you know what provision was made for you at all by your father?

A. Not what provision was made by his will. He had given me during the years enough so that he had built up a slight income for me during the years, and he had educated me so that I was perfectly capable of looking after myself.

Q. Did your mother make a will?

A. She did. [15]

Q. Did you know about that? A. Yes.

Q. Did you know you were the beneficiary of her will?

A. I am her only child; naturally, there was no one else.

(Deposition of Grace Lewis Phillips.)

Q. When did you know it?

A. Right after my father's death she was told by the lawyer she should make out a new will.

Q. And that was in—— A. 1940.

Q. ——1940. From that point forward you were quite familiar with the situation, and that you were the expectant recipient of the stock interest of the bank and Wilbur Security that your father and mother had owned? A. That is right.

Q. Had your mother made a will by 1940?

A. You mean prior to the death of my father?

Q. Yes.

A. Yes, I think they both had wills.

Q. Was that same will in force when your mother died? I mean, did she make any different will——

A. (Interposing) She made a new will immediately after my father's death. I have already stated that.

Q. Mr. Butler asked you about how you reported the money you received from Wilbur Security, this so-called interest, in your 1954 return. I believe he asked you [16] whether you reported it as interest or dividends. Do you recall that?

A. Yes.

Q. You said you reported it as interest?

A. Yes.

Q. Do you know what difference it would make in your return, whether it was reported as interest or dividends?

A. No. I know there is a difference, but I don't

(Deposition of Grace Lewis Phillips.)

know what it is. In other words, a C.P.A. takes care of it.

Q. You were relying on the advice of someone else—— A. Certainly.

Q. ——and if someone else told you to call it dividends, but that was not the right way to call it, you would follow that advice, wouldn't you?

Mr. Castoldi: I object to that question.

A. I object to that question, too, because I know the difference between interest and dividends, and I don't let anyone tell me. I make up my own report to them, and I know what is interest and what is dividends when I turn it over to them to prepare the return.

Q. Did you make up your own return?

A. I did not.

Q. You turned over the factual information and they made it up? A. That is right. [17]

Q. Would you question how they reported income as interest or dividends, or would you follow their advice?

A. I don't deal with people who actually call interest dividends, or dividends interest. I give them the facts of what I know of my income, and they make up the return accordingly. I deal with one of the most reliable C.P.A. firms in the country.

Q. You rely on his judgment largely in those matters?

A. I give him the facts, and he makes it up according to the way he is supposed to make it up.

Q. Are you familiar with the statutory definition

(Deposition of Grace Lewis Phillips.)

of a dividend and in the Internal Revenue laws so far as a corporation is concerned?

A. I probably couldn't quote it, no. No, I wouldn't testify to that.

Mr. Payne: That is all.

Mr. Butler: I want to clear up a couple of questions.

Redirect Examination

Q. (By Mr. Butler): You testified earlier on cross examination by Mr. Payne that when you called Wilbur concerning the fact that you wanted to get money for your taxes and your mother's estate, that you called the bank. Did you mean you [18] called the bank or you called—

A. I meant Mr. McPherson, or Mr. Thompson, who was then living, and who would naturally always be found at the bank during business hours. I mean it was the officers or the people handling the business for the Wilbur Security that could always be found at the bank during banking hours. The people whom I wanted to talk to would be Mr. McPherson or Mr. Godfrey Thompson.

Q. You mentioned also in your testimony, or Mr. Payne elicited, that you owned ninety shares. Was that ninety shares in the Wilbur Security Company, or the bank?

A. In the Wilbur State Bank; and I also testified I wanted to check those figures to be very sure.

(Deposition of Grace Lewis Phillips.)

Q. Do you know how many shares you own now in the Wilbur Security?

A. I am sorry; I don't know.

Q. Did you have any interest in the Wilbur State Bank in the earlier years—any stock interest? A. No.

Q. Now, Mr. Payne asked you if you ever received a note from the Wilbur Security evidencing these amounts, and you said no. Were notes issued evidencing these amounts?

A. So far as I know, there were notes, yes, in Wilbur from the time my father,—away back in his day, that were [19] just customarily and automatically renewed, and they just continued that when I took over the business.

Q. Now, would you state for the record how you dealt with Mr. McPherson? There is the elder Mr. McPherson and the younger McPherson. Concerning these business matters, how did you customarily deal with them?

A. I usually called them on the telephone because I could get a quick answer, and if there is any explanation needed, it is forthcoming, and we could discuss it right on the phone. It is much easier and quicker than writing.

Q. Have you ever discussed this method of doing business with your present attorney who handles your legal matters?

A. May I add, I also go into Wilbur once a year, where we have a very thorough talk on business matters.

(Deposition of Grace Lewis Phillips.)

Q. Did you ever talk about this method of dealing with the McPhersons with your present attorney?

A. He knows how I handle it.

Q. What did he say about it?

A. Well, he thought it was a rather nonchalant way, but having met Mr. McPherson and knowing the relationship between the two families, he began to understand it.

Q. Now, you testified with regard to the amount outstanding in the Wilbur Security account payable or the stockholder account that you discussed it with your father. [20] Did you also have any conversation about whether you could draw this money when you were out of town or traveling?

A. Yes, I always knew from the time I was a young woman that I could draw on that and not be caught stranded somewhere.

Q. Mr. Payne also asked you whether you actually received the interest each year, and, frankly, I didn't understand your answer. How was that handled, to the best of your knowledge at the end of the year,—the interest payment on the "note payable account" in the Wilbur Security Company?

A. Up to Mr. Fisk's death I never received any of this money. After Mr. Fisk's death my father used to give me a monthly allowance, which included what income I had, but how he divided it up or when he got it or what he did, I don't know.

Q. How about at the present time?

A. What do you mean?

(Deposition of Grace Lewis Phillips.)

Q. With regard to these interest payments at the present time, how are they handled?

A. Well, they are usually left there in Wilbur—left in the account the last few years. The last year was the first year I haven't paid inheritance tax or finished paying the inheritance tax. This will be the first [21] year I haven't needed to have money for those purposes.

Mr. Butler: I have no further questions.

Recross Examination

Q. (By Mr. Payne): Mrs. Phillips, you seemed to change your testimony about these notes. You stated on your first cross examination that you never received the notes with respect to those amounts so far as you can recall?

A. That is right.

Q. And then on Mr. Butler's redirect, you stated, as I remember it, that notes were customarily and automatically given and renewed.

A. I think if you will go back to my very first testimony, Mr. Payne, I stated that it was my father's custom to just leave the notes there and automatically renew them, and that has continued. I think if you will go back to the very first time Mr. Butler asked me about it, you will find that is what I said.

Q. Let me ask you specifically about your own deposits. Did you ever see a note with respect to your own deposits?

A. No, I don't think I ever did.

(Deposition of Grace Lewis Phillips.)

Q. And when you say they were customarily and automatically renewed, that is just hearsay from your father? [22]

A. I don't know whether it is hearsay; it is just a thing that happened. That was the way it was handled.

Q. How do you know it happened?

A. I know it happened that way.

Q. Tell us for the record how you know it happened.

A. I know I had to have some receipts for it, and that it is there if I went and asked for it.

Q. But you didn't receive one yourself and you didn't see any other notes and you didn't see and examine the books and records of the corporation, did you?

A. The books and records of the corporation were examined by my lawyer at the time of settling my father's estate, and I am quite sure at that time he undoubtedly saw those notes. They were seen. I wouldn't know what papers were brought into evidence at that time.

Q. Then your answer is that any information that you have on that subject came through someone else, and you didn't physically see it, or know personally about the way in which it was handled?

A. I may have seen it at the time of the settling of the estate, but I can't recall because there were too many things.

Q. Where did you get the information on which

(Deposition of Grace Lewis Phillips.)

you base your statement that the notes were customarily and automatically renewed? [23]

A. Well, I know that my father had some evidence of it. He had the notes, and I know he just simply called the boys, exactly as I do, and the notes were taken care of in that way.

Q. That is an assumption on your part, isn't it?

A. What is the difference between an assumption and knowledge? I know that father——

Mr. Butler: That is all right; just answer the question.

Q. I don't want to argue with you; I just want you to tell for the record. That testimony is based on what someone else told you?

A. I can't go back to the time we examined all the books at the time my father's estate was settled, but I think at that time I probably may have seen them.

Q. Then you stated on redirect examination that once a year you went to Wilbur, and there you had a thorough discussion. When did that begin, so far as you personally are concerned?

A. After my father's death and I had to handle the business.

Q. I believe you testified, though, that you did not acquire any interest upon your father's death, and not until your mother's death?

A. No, but I was administratrix of her estate, and I had to handle all the affairs, and they were gone into—— [24]

Q. Prior to her death in 1951?

(Deposition of Grace Lewis Phillips.)

A. I mean my father's estate. I was administratrix of his estate and her estate, and I handled her business affairs after his death.

Q. You gave some testimony on redirect with respect to the "note payable account." Do you know how that account was carried on the books?

A. I am sorry; I didn't understand you.

Q. Mr. Butler just asked you a moment ago on redirect examination about these amounts in the "notes payable account." Do you know anything about the terminology—meaning that account,—except what someone else told you? Do you know how the account was carried by the corporation?

Mr. Butler: I object to that. I merely characterized it as a "note payable account," because that is the way it is characterized in the books, for the purpose of identification.

Mr. Payne: When you asked her, she assumed that was a fact, and I am asking what she knows about the "notes payable account."

A. I know when I got my report from Wilbur,—the information for the income tax, which would have been mine,—the estate's, and my own, it was written, "Wilbur Security Co. dividends; Wilbur Security Co. interest; State Bank of Wilbur dividends." [25]

Q. So you don't know the name of the account on the books?

A. Yes, I know the name of the account. It was held in my name, and the other account was held in my mother's name or the estate's name.

(Deposition of Grace Lewis Phillips.)

Q. I mean whether the corporation carried it a a "notes payable account," or some other designation?

A. I never saw it.

Mr. Butler: One other question.

Redirect Examination

Q. (By Mr. Butler): Do you have income in addition to the amount you are receiving from the Wilbur Security Company and the Wilbur State Bank?

A. Yes, I do.

Q. Is that in excess of the amounts received from the Wilbur Security and Wilbur State Bank?

A. Yes.

Mr. Butler: I have no further questions. [26]

/s/ GRACE LEWIS PHILLIPS.

[Title of District Court and Cause.]

Be It Remembered that on the 8th day of November, 1957, at the hour of 10:35 o'clock, a.m., at the office of Wilford H. Payne, Assistant Regional Counsel, San Francisco Region, Internal Revenue Service, United States Court House, Seattle, Washington, pursuant to stipulation, personally appeared before me, James R. Royse, a Notary Public in and for the State of Washington, County of King, duly appointed and commissioned to administer oaths:

John McPherson called to testify by deposition at the instance of the petitioner;

Francis J. Butler, Esq., and Paul Castoldi, Esq., Attorneys at Law, appearing for and on behalf of petitioner; Nelson P. Rose, Esq., Chief Counsel, Internal Revenue Service, by Wilford H. Payne, Esq., Assistant Regional [1] Counsel, San Francisco Region, Internal Revenue Service, appearing for and on behalf of respondent;

Whereupon, the following proceedings were had and done, to-wit:

JOHN McPHERSON

being first duly sworn, testified on oath as follows:

Direct Examination

Q. (By Mr. Butler): Will you state your name for the record, please?

A. John McPherson.

Q. And your address?

A. Wilbur, Washington.

Q. Your age?

A. I will soon be seventy-eight. I am seventy-seven, and I will be seventy-eight this month.

Q. When did you first come to Wilbur?

A. February, 1902.

Q. Would you tell us how you happened to come to Wilbur in the first place?

A. I came here to work in the bank as a book-keeper.

Q. What was your position in the bank?

A. Well, I was bookkeeper when I first came, and later on I was assistant cashier. [2]

Q. Anything else? A. I was president.

(Deposition of John McPherson.)

Q. So then you were an officer of the Wilbur State Bank from 1902 until recently?

A. Yes, approximately so until recently.

Q. You were one of the originators or one of the original people in the Wilbur Security Company? A. Yes.

Q. Which was formed in 1915, as the record in the case indicates? A. Yes.

Q. Would you tell us the circumstances which either necessitated or surrounded the forming of the Wilbur Security Company? Would you tell us something about it, and how the company started?

A. Well, the Wilbur Security was formed for the purpose of holding long-time paper which the bank was not permitted to carry,—excess loans that the bank couldn't carry. I don't know if you people understand that in the banking business we are only allowed to carry on the books ten per cent of our capital and surplus. Some customers required more time, so we formed the Wilbur Security Company in order to hold the customers.

Q. How much was put up at the outset for Wilbur Security Company? [3]

A. Originally we put up \$200,000—\$25,000 and \$200,000.

Q. What was the nature of the two hundred thousand?

A. The nature of the two hundred thousand was accounts we had in the State Bank of Wilbur on deposit.

(Deposition of John McPherson.)

Q. Was there any reason for putting it in the Wilbur Security Company?

A. Oh, yes, there was a reason. The reason we did it was because that they were always talking in those days about starting a new bank, and that money belonged,—most of it belonged to Mr. Farnsworth and myself, and my dad, and we put it over in Wilbur Security Company so the bank wouldn't have that amount of deposits that showed. It invited a competition if we showed deposits were more than they really were. That was the idea. So we put it over in order to get it out of the bank.

Q. Did you intend at that time that this money be placed at the risk of the business,—the two hundred thousand dollars? A. No.

Mr. Payne: Objected to as calling for the conclusion of a witness on a point which the Court must decide.

Q. You can testify on your intent. Did you intend that to be at the risk of the business?

A. No, sir. [4]

Q. How much would you have needed in your opinion to start the Wilbur Security Company originally?

A. Oh, to start it we would not need much more than a capital of twenty-five thousand dollars.

Q. Did you give any consideration at the outset to the income tax laws—at the outset of Wilbur Security?

A. No, not the income tax laws in those days.

(Deposition of John McPherson.)

The income tax didn't amount to anything. We never even thought of income tax.

Q. You were an officer in Wilbur Security Company, is that correct? A. What?

Q. You were an officer in the Wilbur Security Company? A. I am not now; I was.

Q. I say, you were?

A. Yes, I was, from the inception of it.

Q. From 1915 to 1939 were you an officer?

A. I was.

Q. Now, you were also a stockholder?

A. I was a stockholder.

Q. And you also in those years, 1915 to 1939, had amounts outstanding in this so-called "stockholders' account"? A. That is right.

Q. Did you also have amounts outstanding in an account known as the "special account"? [5]

A. I did, yes.

(Discussion off the record.)

Q. How did you in your own mind characterize the amounts outstanding in the "stockholder account" and the "special account" from 1915 to 1939?

A. I considered them loans to the company.

Q. Could you have withdrawn those sums?

A. Yes, I could.

Q. Did you ever withdraw any?

A. I think I did at times. We did at one time withdraw some.

Q. How about with regard to the "special account"? A. Yes, I withdrew some.

(Deposition of John McPherson.)

Q. That account fluctuated, the record will show? A. Yes, but not too much.

Q. Did you surrender any stock when you took back some of this amount that was outstanding?

A. No.

Q. As to these amounts in these two accounts, the "stockholder account" and the "special account," from 1915 to 1939 did you have any notes for these amounts?

A. No, we didn't up to 1939, no.

Q. Why didn't you have?

A. The reason we didn't do it was because in those days we were permitted to pay interest on open accounts, but [6] after that we weren't on account of the Revenue Department. They insisted we could only allow interest on notes.

Q. In 1939 the minutes of the corporation show that the "stockholder account" and the "special account" were consolidated. The minutes indicate that? A. Yes.

Q. The "stockholder account" was, according to the minutes, paid off. What were the mechanics of that transaction, if you recall? Did you actually receive the two hundred thousand dollars at that time? A. My portion of it.

Q. You did receive your portion of it?

A. Yes, I did receive it.

Q. And what did you do with it?

A. I put it in my account.

Q. In your account?

(Deposition of John McPherson.)

A. Moved it into the,—consolidated it with my own account.

Q. Was it just a book transaction?

A. Just a book transaction, yes.

Q. But it was your understanding that that was——

A. (Interposing) That it was a book transaction.

Q. Now, I am talking about 1939 again, when this consolidation took place. Did you have notes evidencing [7] the amount of that special account?

A. Yes, I did.

Q. In 1939?

A. I beg your pardon. I never had notes until—it was some time after that that we had notes.

Q. How would you characterize in your mind the amount outstanding in the “special account”? How would you characterize it?

A. I would characterize it as a loan to Wilbur Security at that time.

Q. Did you at that time have the same ratio of stock and account ownership? A. No.

Q. Was the ratio between stock ownership and your account the same? A. No.

Q. Was this amount in the “special account” at the risk of the business? A. No.

Q. Why wasn't it?

A. Well, because it was subject to withdrawal. It was just a loan.

Q. Would the amount outstanding in the “spe-

(Deposition of John McPherson.)

cial account" have been prior to the stock ownership if the company had folded up? [8]

Mr. Payne: I object to that as calling for a conclusion of the witness on a point the Court has to decide.

Q. Would you, in effect, be ahead of the stock by virtue of this "special account"?

Mr. Payne: I object to that as calling for a legal conclusion.

Q. You may answer. A. No.

Q. I will rephrase the question. You had an amount outstanding in the "special account"?

A. Yes.

Q. And you had a stock ownership?

A. Yes.

Q. If the company had gone defunct for some reason, would your amount in the "special account" have taken precedence over the stock account?

Mr. Payne: That calls for a conclusion and the respondent renews the objection.

Q. You may answer.

A. Yes, I think it would.

Q. Now, in 1943, the minutes of the corporation indicate that a new account was set up called "notes payable account," and it was set up by transferring over the old "special account" balance. The minutes indicate [9] that the directors were to issue notes. Now, my question is, were notes issued in 1943?

A. Yes, there were.

Q. What kind of notes were they?

(Deposition of John McPherson.)

A. Promissory notes. Just notes payable to the depositors who wanted to put money in it.

Q. Did you get one? A. Yes, I did.

Q. Was it renewed each year?

A. Yes. I think there were two or three years——

Mr. Payne: Let me stop right at this point. We are going to object to this testimony as not being the best evidence.

Mr. Butler: The best evidence rule applies to contracts, wills and leases, and would have no applicability.

Mr. Payne: You are asking now about notes to cover hundreds of thousands of dollars over periods of time, and I object on the ground that this witness cannot be expected to remember all the details of those accounts, and I am calling for the best evidence.

Mr. Butler: I will get to that.

Mr. Payne: I just want it understood I am going to object to it.

Mr. Butler: All right. Fine. The objection [10] is noted.

Q. Were the notes renewed each year?

A. My own, the one I got, is in my safety deposit box.

Q. I am talking about the years 1943 to 1950. You have testified you had notes,—notes were issued, and that you had a note?

A. I had a note, yes.

Q. Were they renewed each year?

(Deposition of John McPherson.)

A. I think they were. There might have been a year or two, but they were renewed because interest was always paid on them, which renews them.

Q. What happened to the note? Did you turn it in and get a new note each year?

A. Yes, mostly we did. There was a year or two I don't think we did.

Q. Where are those notes now?

A. My note is in my own possession.

Q. I am talking about the old notes?

A. Oh, I don't know.

Q. What happened to the old notes?

A. What happened to the old ones? I kept some of those, and what happened was that we had a flood over our way, and we had them all stored in the basement, and all our files down there were ruined by the mud and water coming in and ruining everything in the basement,—the Security [11] Company files and my files. I had my private files down there. It ruined all them. Most of them were just destroyed, but the old notes weren't any good. We didn't figure there was any need to keep them, but I used to keep them——

Q. That is all right. I have a picture that I am going to try to add to this stipulation.

(Discussion off the record.)

Q. We were talking about your notes of the Wilbur Security Company being in this building.

A. Yes, my own.

Q. Now, I am talking about the "notes payable account," which came into being in 1943. How

(Deposition of John McPherson.)

would you in your own mind characterize the amount that you had outstanding in that account?

A. Well, it was a loan to the company,—an amount to me from the company.

Q. You understand, Mr. McPherson, that we are at issue here concerning the nature of the amount in this account,—whether it was a loan, or whether it was a contribution of capital?

A. It was a loan.

Q. I am going to ask you, do you recall if in other years you had this same argument with the Internal Revenue Service concerning what was the nature of this account? [12] A. Yes.

Q. Do you remember when that was?

A. Oh, that was along in 1938 or 1937,—somewhere along in there.

Q. Did any Internal Revenue agents investigate the account in the early forties, or the forties?

A. Yes.

Q. Was this question ever brought up at that time? A. Oh, yes.

Q. And what was the result of it?

Mr. Payne: I object to that as calling for evidence from this witness which is not the best evidence. There must be some written responsible document.

A. The case was dismissed.

Q. The case was dismissed. Did you pay any additional tax?

A. No, we didn't pay any additional tax.

Q. Did you ever—and I am talking about the

(Deposition of John McPherson.)

amount outstanding in the "notes payable account,"—did you ever subordinate this amount to other loans? A. Absolutely not.

Q. Were you ever requested to do so?

A. Yes, we were requested at the time we made some loans, and we told them we would not do it.

Q. Now, the by-laws of the corporation, [13] which will be in evidence eventually, originally provided that if you transferred a share of stock in the Wilbur Security, you also had to transfer an eight-hundred dollar amount in the "special account." How long was this provision in effect, do you recall?

A. I think up until the thirties. I forget what year.

Q. Were the by-laws actually changed at that time? A. I don't think so.

Q. Were there amounts transferred after 1938, to your knowledge, which didn't include part of the accounts payable?

A. Yes, they were transferred. I think along about 1938, somewhere along there, they were consolidated with our other account.

Q. After 1939, when the new people came into the company, were they told about this provision in the by-laws?

A. Well, they knew about it, yes.

Q. Were they told about it? A. Sure.

Q. The people who came in after 1939?

A. You mean the new stockholders?

Q. Yes. A. No, not to my knowledge.

(Deposition of John McPherson.)

Q. Do you understand the distinction between a loan and a stock ownership? [14]

A. Oh, yes, sure.

Q. Would you explain in your own words what you think the distinction is?

A. Well, of course, a stock is capital of a company, and it has voting rights, whereas notes are just a loan representing money loaned,—a note given to a party for money due; that is a promissory note.

Q. How would you characterize the amount which you had outstanding in the “notes payable account” during these years in question?

A. Well, I would consider it a loan.

Q. Now, you had during the years 1915 to 1917 amounts outstanding in both a “stock account payable” and a “notes payable account” of the Wilbur Security Company, is that correct?

A. What is that?

Q. During each of the years 1915 to 1956 you had an amount outstanding in both the stock accounts,—you owned stock—and you also had an amount in the “notes payable account”?

A. Yes.

Q. Now, during some of these years was the value of this stock depressed? Did it go down some years,—the value of the stock?

Mr. Payne: I object to the question as calling for a conclusion. [15]

Q. You may answer.

A. What do you mean by “depressed”?

(Deposition of John McPherson.)

Q. During some years, the earlier years, did the value of the stock go down?

A. Maybe it did; it would probably fluctuate.

Q. Did this fluctuation have any effect on the "notes payable account"? A. No, not a bit.

Q. With regard to the non-stockholders like your sister—did she own any stock in the company? A. No, never did.

Q. Did this increase in stock values affect her "notes payable account" in any way?

A. Absolutely not.

Q. Are you a stockholder in the Wilbur Security Company at the present time?

A. No, not now.

Q. Are you a note holder?

A. Yes, I am a note holder.

Q. When did you sell your stock in the Wilbur Security Company? A. December, 1956.

Q. How much do you have now in the note account? A. \$197,000, I think. [16]

Q. Do you have any managerial rights in the company? A. No.

Q. Are you an officer of the company?

A. No, I am not.

Q. Is that \$197,000 at the risk of the business?

A. No, not at the risk of the business; it is a loan to them,—an out-and-out loan.

Q. Now, is Godfrey Thompson or his widow a stockholder and note holder in the Wilbur Security Company? A. Not now; we paid her off.

Q. When did you pay her off?

(Deposition of John McPherson.)

A. We paid her off last December.

Q. Is she still a stockholder?

A. She is a stockholder, yes.

Q. How about Mr. E. H. Oswalt? Is he still a note holder?

A. No.

Q. Is he still a stockholder?

A. He is a stockholder, yes. He has been paid off. We paid him off. He needed it for reinvestment. He could get more interest than we paid, and he wanted his money, and we paid him off.

Q. Will you, by virtue of this amount outstanding in the "notes payable account" share in the profits of the company?

A. Not a cent. [17]

Mr. Payne: I object to that as calling for a conclusion of the witness, and I would like to move that the answer be stricken and let the record so show.

Q. Are you familiar with the interest rates that have been paid on this loan account over the years?

A. Yes.

Q. As a banker, would you characterize those amounts as an excessive rate of interest?

A. No, I never considered it excessive. I never considered five or six per cent an excessive interest rate.

Q. How large is Wilbur?

A. Oh, about 1100 people.

Q. How would you characterize or how would you state the nature of the relationship among the stockholders and the note holders in Wilbur Secu-

(Deposition of John McPherson.)

rity Company? Were they on a friendly basis? Would you care to comment on it? I mean, did they get along together or how did they get along?

A. Oh, they got along all right there.

Q. Would you say that business in a small town by a small town banker like yourself is conducted in the same manner that you would conduct a bank in Seattle or one of the bigger cities?

A. No, no; no, I don't think so. We are more intimate with our customers than they are. [18]

Mr. Butler: I have no further questions.

Cross Examination

Q. (By Mr. Payne): Mr. McPherson, you testified that you had held various positions in the Wilbur Security Company and various positions in the bank at Wilbur? A. Yes.

Q. Would you identify the name of that bank?

A. The State Bank of Wilbur.

Q. You gave some general testimony about the incorporation of the Wilbur Security Company, and Mr. Butler asked you how much money you put up. You first testified that you put up two hundred thousand dollars, and then you later referred to twenty-five thousand dollars? A. Yes.

Q. Do you remember how the twenty-five thousand dollars so-called capital stock was paid?

A. There was no capital stock paid in. The capital stock was built up from the earnings of the company.

(Deposition of John McPherson.)

Q. Why did you put in the two hundred thousand dollars?

A. Well, as I said, we put in the two hundred thousand dollars to get it out of the bank. It was all on open account in the bank to the credit of each individual that was a stockholder in the bank. You understand the [19] stockholders in the bank and the stockholders in the Security Company owned the stock in proportion.

Q. How long did that continue?

A. Oh, that continued up until,—I think it continued up until along about 1938; sometime in there, about 1938. (Pause.)

Q. Just use your best—

A. It is hard to remember offhand.

Q. Now, Mr. McPherson, what did Wilbur Security Company do with the \$225,000?

A. What did they do with it?

Q. Yes.

A. Well, we loaned it out. We loaned the money out and carried notes and real estate and mortgages, and so on.

Q. In the same type of operation as the bank had been engaged in?

A. Practically so, yes.

Q. How long did that continue?

A. It still continues. It has continued all the time I was in there. It has always continued that way.

Q. Are you familiar with the operation of Wilbur Security in the years 1953, 1954 and 1955?

(Deposition of John McPherson.)

A. I am, yes.

Q. Is it still loaning money?

A. Yes. [20]

Q. Does it own some farm lands?

A. Yes.

Q. Do you know to what extent the assets of the corporation were represented by farm lands and real properties in 1953, 1954 and 1955?

A. You mean the farm lands is the principal part of the company? A. Yes.

Q. That is the principal part of your earnings, too, isn't it?

A. Yes, the principal part of the earnings.

Q. You don't have any earnings from interest and dividends?

A. Oh, yes, we do; yes, we do.

Q. Do you know how much money was invested in farm lands in 1953, 1954 and 1955, relatively?

A. How much was invested in farm lands?

Q. Yes.

Mr. Butler: I request that that be clarified as to whether counsel for the Government means how much was invested, or what was the fair market value of the farm properties in the years in question.

Mr. Payne: This is cross examination. He may answer any way he wishes to.

Q. Do you know what amounts you had invested in farm lands in those years?

A. I can't remember the exact amount, but I imagine it was some \$500,000, or more. [21]

(Deposition of John McPherson.)

Q. That is all I want, your best judgment.

A. It is hard to remember.

Q. Were those lands owned outright by Wilbur Security? A. Yes, by Wilbur Security.

Q. Do you know when they were acquired?

A. At different times. A lot were acquired through foreclosure, and a lot were acquired through parties deeding them over to pay the obligation that they owed us.

Mr. Butler: I might, if I may interrupt, say we have a list of those farm lands which we intend to stipulate and will gladly indicate when they were acquired and for how much, and any further information regarding the same.

Mr. Payne: This testimony has been very general up to now, and I suppose we will keep it that way.

Q. From time to time in addition to the two hundred thousand dollars, Wilbur Security took from stockholders and from others large amounts of money on so-called loans, is that right?

A. That is right.

Q. Was that money used to acquire the farm lands?

A. Well, no, not—it was indirectly, yes. We used a lot of it to pay off the mortgages that was on them that came due, and it was for different loan purposes,—to [22] carry some large accounts that the bank couldn't take care of—overloans. We loaned money in order to hold the customers.

Q. So these so-called loans to the corporation really found their way into the substantial assets

(Deposition of John McPherson.)

which constitute the working capital of the corporation, did they not?

A. No, I don't think so. Of course, if we borrowed the money, we had to pay interest on the loan,—on the bills payable.

Mr. Payne: I am going to ask him some questions about this return and let him testify from his knowledge of the return and the figures in the return.

Mr. Butler: I object to giving him the return on cross examination on the ground that it exceeds the scope of the direct examination. You are asking him to testify about a return that he has no independent knowledge of, other than as an officer of the corporation. He didn't make out that return, and he would have to establish that he had something to do with making out the return other than just signing it as an officer of the company.

Mr. Payne: You may object to it, but I will make the record.

Q. I show you a document, Mr. McPherson, which is entitled, "Wilbur Security Company, Wilbur, Washington—United States Corporation [23] Income Tax Return 1953." At the bottom are two signatures, and I ask you if you can identify them?

A. Yes, that is my signature.

Q. As president of the corporation?

A. That is right.

Q. And G. Thompson is secretary of the corporation?

(Deposition of John McPherson.)

A. Yes; he has passed away. He isn't living now.

Q. I show you a so-called balance sheet attached to that return as of December 31, 1952.

A. Yes.

Q. Merely to refresh your recollection on the matter about which I asked you a moment ago, you stated that you recall that the farm lands were probably up around \$500,000?

A. It is \$439,000.

Q. \$439,503.07?

A. That is right.

Q. Which is stated in the assets account in that balance sheet?

A. No, it wasn't the total assets.

Q. I say, that is in the assets account?

A. Yes, it is in the assets account.

Q. That is the farm lands?

A. That is right. [24]

Q. Do you know whether that is based on value or on the cost?

A. That is on the cost—the actual cost of them.

Q. Now, I show you another schedule attached to that return for the year 1953, showing a list of so-called bills payable as of December 31, 1953, with a list of individuals and estates, and so forth, from whom those amounts were apparently secured, and ask you to give us the sum total of that list?

A. \$552,518.40.

Q. Do you think that any part of that \$552,518.40 is represented in the farm lands account just mentioned?

A. Represented in this?

Q. Yes.

(Deposition of John McPherson.)

A. It is not represented in this. That was the money we loaned the company.

Q. What happened to that money?

A. What?

Q. What happened to the \$552,518.40?

A. What happened to it?

Q. Yes, what did you do with this money?

Mr. Butler: I object to the materiality of that question.

Mr. Payne: Let the record show his objection.

Mr. Butler: I don't think it makes any [25] difference.

A. The company used it for investment, of course.

Q. Those investments are represented by your farm lands?

A. Not altogether; also bills receivable—other bills receivable. Farm lands is only part of it. Of course, that is a big part of it, but we loaned a lot of that money out for other purposes, too,—for notes and mortgages and so on.

Q. If the bills payable had been demanded in the sum of \$552,518.40, could Wilbur Security have paid this amount in 1953? A. Absolutely.

Q. Where would you get the money from?

A. We were offered it from several different sources. If we wanted it, we could have gone out and borrowed it any time. We have an open credit from a bank.

Q. You mean, you would have to borrow it in order to pay it off?

(Deposition of John McPherson.)

A. Well, yes, or call in some of our loans, or sell some of our farm lands.

Q. So that the so-called "bills payable accounts" were tied in the operations of the company, weren't they? A. Every company has that——

Q. And you couldn't have paid it off without borrowing the money or selling your farm lands, could you? [26]

A. Well, no, I don't suppose we could have without liquidating the company, or borrowing it; but we could have borrowed it. We were offered the money, and at different times we have to look for loans of our own. But we were offered the money to pay it all off, absolutely. It would have been very easy. We could have paid off.

Mr. Butler: Just answer the question.

(Discussion off the record.)

Q. Mr. McPherson, is it your understanding that the same relative situation continued with respect to the farm lands which were owned by Wilbur and the so-called loans account of Wilbur throughout the years 1954 and 1955?

A. 1953, 1954 and 1955.

Q. We just talked about 1953. I say, is it your understanding the same general conditions prevailed in the subsequent two years?

A. Yes, I think the same condition prevailed.

Q. There was no change in the relative position, was there?

A. I don't hardly think so. I don't know, but I don't think so. Maybe a minor change.

(Deposition of John McPherson.)

Q. You still owned substantially the same farm lands and other assets, and you still had these so-called bills receivable? [27]

A. There was probably some change in the bills receivable. They fluctuated up and down.

Q. There was some testimony about which I am not clear, and I am not sure the record is clear, on the difference between the "special account" and the "stockholders account." What is your understanding of the so-called "special account"?

A. My understanding of the "special account"? In what way do you mean?

Q. Mr. Butler asked you about those two different accounts, and you gave testimony about it on which I am not clear. Reiterate your understanding of the "special account."

A. The "special account" was just money loaned the company and any interest on it; that was all there was to it.

Q. Is that "special account" the original two hundred thousand dollars that you put in?

A. No.

Q. What was it?

A. I didn't put in the two hundred thousand dollars. That was the stockholders who put it up.

Q. I mean the stockholders. You are testifying now as a stockholder of the corporation too?

A. That is right.

Q. And an officer?

A. Yes. [28]

(Deposition of John McPherson.)

Q. Do you know how the two hundred thousand dollars was designated on the books?

A. Yes, "stockholders account."

Q. You say that was the "stockholders account"?

A. Yes.

Q. Then what was the "special account"?

A. The "special account" was just money that belonged to the individual people that they left with the company.

Q. Was one of those accounts subject to restrictions or limitations?

A. Not at all. There were no restrictions or strings to it at all.

Q. What about the two hundred thousand dollars that the stockholders put in at the time of the organization? Was that subject to any restrictions?

Mr. Butler: Would you clarify that as to time? Restrictions during what time?

Mr. Payne: At the time it was put up.

A. At the time it was put in, yes.

Q. What were those restrictions, if you know?

A. The restriction, as I understand it, was that whoever bought out the stock would have to put that much money in the company. Of course, that was at the time that we organized it.

Q. How many shares did the Wilbur Security Company issue in the beginning? [29]

A. 250 shares.

Q. At \$100 par?

A. One hundred dollars par.

Q. That is represented by the \$25,000?

(Deposition of John McPherson.)

A. The \$25,000.

Q. That was later put in out of earnings?

A. What?

Q. That was later put in out of earnings?

A. Yes, that is right. It built up from earnings.

Q. In 1916, or do you remember the year?

A. Some time in there, yes. I think it was some time in those years.

Q. Now, \$200,000 was put in subject to limitations, wasn't it?

A. Yes, I think the record will show it.

Q. That represented \$800.00 per share?

A. Well, in a way, I guess it did, yes.

Q. And it is your understanding the shares could not be assigned or transferred without the additional \$800.00 per share going with it?

A. No, I don't understand it that way.

Q. You don't? A. No.

Q. What do you understand? [30]

A. Would you let me explain it?

Q. Yes.

A. The reason we had it that way was that if the shares were put up for sale, we didn't want it to go outside. For instance, if anybody wanted to sell his shares, he would give the present stockholders the first opportunity to buy out that stock, and if we didn't want to accept it, he could go out and sell it on the outside and withdraw the money. But we wanted the right to buy it first if we wanted it. He could offer it to us first, and if we didn't take it at that price, then he could

(Deposition of John McPherson.)

go out and sell it to whoever he pleased. We reserved that right. Our by-laws will show that.

Q. Do you remember the resolutions of the corporation which were passed with respect to the \$200,000? A. Yes.

Q. Do you remember what those resolutions provided?

A. Well, not just word for word, I don't know what they provided; but they provided that that amount was to go with the stock, yes.

Q. And that the stock not be assigned or transferred without the proportionate part of the \$200,000 going with it?

A. Yes, it was at that time. You are speaking now of away back when we organized the company?

Q. Yes. A. Yes. [31]

Q. I believe you indicated that that condition was changed? A. Yes, it was changed.

Q. When?

A. Along about in 1938; I think somewhere in there.

Q. What change took place at that time?

A. Well, we paid off the two hundred thousand dollars.

Q. Were you still a stockholder at that time?

A. Yes, I was a stockholder at that time.

Q. Did you get the money?

A. I got my money, yes.

Q. In hand? A. The same thing, yes.

Q. You say "the same thing." How did you get it?

(Deposition of John McPherson.)

Mr. Butler: He has already covered it on direct examination.

Mr. Payne: I am going to ask it again.

A. I got it by delivering them—just giving me a credit; I didn't get the money, but giving me a credit on the regular account for it.

Q. So you never drew anything out?

A. No, I never drew it out.

Q. It was just a bookkeeping conversion?

A. It was at my request, yes.

Q. Did all the rest do the same thing?

A. I don't know whether they did or not. I don't remember. [32]

Q. You didn't lose any of the interest on your share of the \$200,000, did you?

A. No, I don't think so. We did the first year. (Pause.) No, no, I wouldn't lose any interest. I don't think we did.

Q. You say the change was made in 1938 or 1939? A. Yes, at the end of the year.

Q. Was that made by a bookkeeping entry?

A. Yes, I think so.

Q. And under the arrangement you had you continued to draw interest on the proportionate interest you had as represented by the two hundred thousand dollars?

A. Yes, I guess so. It was deposited back in, and we received interest, of course.

Q. Did you receive a note with respect to the deposit back?

A. Let's see. I don't remember. (Pause.)

(Deposition of John McPherson.)

Mr. Butler: Clarify the year.

Mr. Payne: He is the witness; I am not.

A. (Resuming) I don't remember whether we did at that time or not. I can't remember; but we received notes later on for it.

Q. That is what I want to know. Why did you leave it in,—your portion of it?

A. To get interest on it.

Q. Couldn't you get interest some place else?

Mr. Butler: That is immaterial and objected to.

Mr. Payne: This is cross examination, and [33] I reserve the right to ask him. He was the president.

A. I suppose so.

Q. Would the bank pay that kind of interest?

A. No.

Q. What kind of interest would the bank pay?

A. At that time we weren't paying anything. We pay three per cent, but we weren't paying interest on deposits at all at that time. We didn't accept savings accounts.

Q. Mr. McPherson, Mr. Butler asked you, and and you gave some testimony about the ratio of the stock and the "special account." Do you remember that? A. Yes, I do.

Q. And then he asked you specifically about the \$200,000, and asked you if it was at the risk of the business, and you said no.

A. It wasn't at the risk of the business.

Q. Where was the \$200,000 put by the corporation, do you know?

(Deposition of John McPherson.)

A. I just told you it was put in there in order to take it out of the bank,—to get it out of the bank.

Q. Did you just put it in the vault and leave it there? A. No. [34]

Q. What did you do with it?

A. We invested it.

Q. In what?

A. We turned over notes at that time, and different things, to the company, and overloans. We turned it over to them so that we could get earnings from them.

Q. You don't know what kind of loans it was invested in?

A. Most of the time when we first started it would be all notes and mortgages. We didn't have any farm lands at that time,—when we organized the company. We took those farm lands afterwards,—made investments in farm lands afterwards.

Q. Suppose those notes that Wilbur Security took were worthless—became worthless——

A. They weren't worthless, of course. They were paid.

Q. ——would you say, then, that the investment was at the risk of business operations?

A. No, it wasn't at the risk of business operations.

Q. It wasn't? A. No.

Q. You mean money out on notes which Wilbur took? A. Yes.

(Deposition of John McPherson.)

Q. Suppose Wilbur couldn't make collection of notes?

A. Suppose Wilbur Security couldn't collect their notes?

Q. Yes. [35]

A. They would lose their money.

Q. What would there be to pay the two hundred thousand dollars with?

A. What would there be to pay the two hundred thousand dollars with?

Q. Yes.

A. Well, I don't suppose we could, if the assets of the company were no good. We couldn't pay it if the assets were no good.

Q. So the two hundred thousand dollars was protected, of course, on whether—

A. —whether the assets of the company was worth it, but we figured they were a preferred account over and above the stock. The stock would be last.

Q. You testified on direct that in 1943 the "notes payable account" was represented by notes which were issued by Wilbur? A. Yes, that is right.

Q. You stated that those notes were renewed?

A. Yes.

Q. Do you know how that was accomplished?

A. By giving new notes.

Q. Each year?

A. Yes, practically each year.

Q. Why do you say "practically"? [36]

A. I think there was a year or two that we

(Deposition of John McPherson.)

just made the endorsement of interest on the back of the old note, and as far as that is concerned, when we paid the interest on them, that renewed them.

Q. You testified on direct about the consolidation of accounts in 1938, which was accomplished by the by-laws? A. Yes.

Q. What was your understanding of that?

A. We consolidated the accounts because there was no use having two accounts in the Security Company.

Q. What you mean is that the former "stockholders account," and the former "special account" were consolidated at that time?

A. Yes, practically so.

Q. And then you testified the new people were advised of that change?

Mr. Butler: I am going to ask counsel to clarify it. I don't think the witness understands.

A. I don't think we had any new people that I know of, outside of Mrs. Phillips. It was the same old stockholders, with the exception of Mrs. Phillips.

Q. You said they were advised of the change, or words to that effect. What did you mean?

A. They knew about the change.

Q. What do you mean by that? [37]

A. Well, they were advised of the change because most of them were represented at stockholders' meetings when we did it.

Q. First, what do you mean by the "change"?

(Deposition of John McPherson.)

A. We changed it,—you are talking about the change from one account to the other?

Q. The consolidation as reflected by the by-laws, according to your original testimony. What was the change?

A. We just consolidated the two accounts,—just moved them together. There was no use having two accounts. We took a note for the whole thing with a specific due date on it.

Q. You testified that you are no longer a stockholder in Wilbur? A. Yes, that is right.

Q. But that you have money on deposit with the company, \$197,000?

A. I have a note for that, yes.

Q. Is that an annual note?

A. No, the note is due in two years.

Q. When did that begin?

A. Last December.

Q. So we are talking about a time subsequent to the taxable years we have under consideration in this proceeding?

A. I took that note last December. [38]

Q. When you say “last December,” that note was given you in December, 1956?

A. Yes, December, 1956.

Q. Were you an officer and stockholder up through 1955? A. Yes.

Q. When did you cease to be an officer and stockholder?

A. In January of 1957. Really, in December,

(Deposition of John McPherson.)

1956, as far as that is concerned. I sold out and resigned.

Q. Now, Mr. McPherson, Wilbur has for a long period of years had the so-called outstanding accounts, or "notes payable account"?

A. Yes.

Q. Or bills payable accounts. They are referred to in different terminology. Is it true that Wilbur has not always paid interest on those?

A. Yes, during the depression we didn't have earnings, and we didn't pay interest, no.

Q. The people who had made those advances were pretty close to the officers of the corporation, weren't they?

A. Oh, yes.

Q. And the officers of the corporation knew better than anyone what the standing of the company was, and what the business expenses or losses were?

A. Yes.

Q. Have you been an officer of the Wilbur State Bank during [39] the same period of years that you have been an officer of Wilbur Security?

A. Yes, I have. Well, I was officer of the bank before we formed the Security Company.

Q. Now, as an officer of Wilbur you realized that you had a very large amount of so-called borrowed money over a long period of years?

Mr. Butler: I object to the form of the question. It assumes a premise that is not called for.

Q. You testified that the borrowing had been up around \$500,000 over a period of years, is that correct?

(Deposition of John McPherson.)

A. Yes; in some years it was more than that.

Q. You are perfectly familiar with that, aren't you?

A. Yes.

Q. And as an officer of the corporation?

A. Yes, I was familiar with that.

Q. You know it of your own knowledge without resort to any papers or records? You remember that? The answer is "yes"?

A. I was familiar, yes.

Q. You haven't always paid the same rate of interest on those borrowings, have you?

A. No.

Q. Why?

A. Well, it would depend on the demand for money. [40]

Q. Who determined that?

A. The note holders,—whether they were going to let us have it for more or for the same interest rates.

Q. Didn't the officers of the corporation determine that from year to year?

A. They determined whether they would pay it or not, yes.

Q. You are in the banking business and are familiar with business operations and the value of securities and different types of securities. Did Wilbur ever attempt to borrow the money it needed in its operations from some other sources?

A. Yes, we have borrowed money from some other sources, quite a little, at different times.

Q. Did you ever attempt to borrow the money

(Deposition of John McPherson.)

to replace the half million dollars which you borrowed from the stockholders and members of families of stockholders? A. Yes, we did.

Q. When?

A. In 1956 or 1955,—I forget which; but one of those years.

Q. How about the year 1953? Did you make any attempt to borrow the money?

A. No. We were offered the money to pay them all off.

Q. By whom? A. By a bank. [41]

Q. What bank?

A. The National Bank of Commerce at Seattle.

Q. When?

A. It was in 1956—I think it was in 1956.

Q. At what rate of interest?

A. Four and three-quarters; I forget, but some per cent like that.

Q. What was the decision of Wilbur Security?

A. Well, we decided that we wouldn't take it, but let it run the way it was at 5 per cent for two years. They wouldn't agree to let us have it except from year to year; so we got it for two years, and now we are carrying it at 5 per cent, the way it was, on a two-year note. We felt that that was better for us than not to know we could renew it. We didn't know how business would be. So we thought we had better pay a little more interest and have that privilege. They wouldn't give it for two years. They said interest rates fluctuated, and they didn't know if they wanted it for two years.

(Deposition of John McPherson.)

Q. I believe it is true, is it not, that the amount of money advanced to Wilbur over the period of years we are talking about was by either the stockholders in Wilbur, or by members of the immediate families of stockholders?

A. No, I don't think so. [42]

Q. Do you know of any variation?

A. I think there was.

Q. Can you identify it as to the year and name?

A. No, I can't, unless I had access to the books.

Mr. Payne: That is all.

Redirect Examination

Q. (By Mr. Butler): Did you have any controversy with regard to the valuation of the stock in the Wilbur Security with the Internal Revenue Service at the time your wife died?

A. Yes, I did.

Q. What did you eventually value the stock at? First, when did she die?

A. We had a controversy with them in regard to the valuation.

Q. What year was that?

A. 1953, I think.

Q. Now, what did you value the stock at?

A. \$2300 a share.

Q. That was the amount agreed upon?

A. What?

Q. That was the amount agreed upon with the Revenue agents?

(Deposition of John McPherson.)

A. Yes, \$2300 a share. That is what we settled with them on. [43]

Q. Now, Mr. Payne showed you some income tax returns of Wilbur for the year 1953, and he showed you a balance sheet which indicated a number of farms, and at the bottom it showed a value of \$453,000, or whatever the value was. Did you testify that that value was the amount that you paid for the farms?

A. Yes, what we carried them on the books—what we took them in at.

Q. Have you had quite a bit to do with the real estate valuations over the years as a banker?

A. Yes.

Q. Are you familiar with real estate values in Wilbur, in and around Wilbur, and particularly farm lands? A. Yes.

Q. What in your opinion is the fair market value, or would have been the fair market value of those farms in 1953, 1954 and 1955?

Mr. Payne: I object to that without identifying the farms, their location, their nature, the acreage and related matters. To just ask generally whether he knows without knowing which farms we are talking about is certainly objectionable.

Mr. Butler: I am speaking about the farms owned during the years 1953, 1954 and 1955,—all of the farms owned by the Wilbur Security Company. [44]

Q. What in your opinion would be the fair market value of those properties?

(Deposition of John McPherson.)

Mr. Payne: I object again.

Q. Go ahead and answer?

A. I think something over a million dollars.

Q. How much over a million dollars?

A. Probably a million two hundred thousand.

Q. Now, we were talking, both myself on direct and Mr. Payne on cross examination, about this resolution that was adopted in 1915 or 1916 that said in effect that when you transferred a share of stock you also had to transfer a part of the stockholder account. Do you remember the resolution?

A. Yes.

Q. Was that adhered to after 1938?

A. No, it wasn't in existence after that.

Q. Wilbur Security Company borrowed money from people who were not stockholders of the corporation, is that correct?

A. Yes.

Q. And did those people have any part in the management of the corporation?

A. Not a bit; nothing to say about it.

Q. Now, you stated in cross examination that the note holders determined whether the interest was to be paid, [45] and then later you said whether interest would be paid was determined by the officers of Wilbur Security. Who in effect determined whether interest would be paid?

A. I don't know what you mean.

Q. Well, did the corporate officers or the note holders?

A. Yes, we determined whether we would pay interest,——

(Deposition of John McPherson.)

Q. Who is "we"?

A. —and what rate we wished to pay.

Q. Who is "we"?

A. The company,—the officers of the company.

Q. Now, as a note holder in the Wilbur Security—when I saw "note holder," I have in mind either in the "stockholder account" during these years, the "special account," or the note account,—during the depression years, if you had taken your money out of the Wilbur Security Company, could you have loaned that money to somebody else at the same interest rate?

Mr. Payne: Objected to as calling for a conclusion and not for a fact.

A. Yes, obviously.

Q. Could you have loaned it with the same security behind the loan as you had at the Wilbur Security Company?

A. Well, I don't think so; I don't know. No, I don't think we could have. We had a lot of assets in the company. [46]

Mr. Butler: I have no further questions.

Mr. Payne: No further questions.

/s/ JOHN McPHERSON. [47]

Certificate of Return of Deposition Attached.

[Endorsed]: Filed December 26, 1957.

[Endorsed]: No. 16496. United States Court of Appeals for the Ninth Circuit. Wilbur Security Company, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Petition to Review a Decision of The Tax Court of the United States.

Filed: June 4, 1959.

Docketed: June 10, 1959.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for
the Ninth Circuit.

In the United States Court of Appeals
for the Ninth Circuit

No. 16496

WILBUR SECURITY COMPANY,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

STATEMENT OF POINTS RELIED UPON

Comes now the Petitioner and asserts the following errors which it urges on Review by the United States Court of Appeals for the Ninth Circuit of the decision of the Tax Court of the United States Court reported 31 T. C. No. 92.

1. That the Tax Court erred in holding that the amounts which petitioner had outstanding in its

bills payable account during each of the taxable years 1953, 1954 and 1955 were equity invested capital rather than loans.

2. That the Tax Court erred in holding that the payments made by the petitioner on the amounts outstanding in its bills payable account for each of the taxable years 1953, 1954 and 1955 were dividends and not interest payments, deductible as such for Federal Income Tax purposes, in computing its corporate income tax for such taxable years.

3. That the Tax Court erred in failing to find that the amounts outstanding in petitioner's bills payable account during each of the taxable years 1953, 1954 and 1955 represented a loan to the petitioner and that the payments made by the petitioner in each of the taxable years were interest payments fully deductible in arriving at taxable income for the said taxable years.

4. That the Tax Court erred in failing to include in their Findings of Fact material matters which transpired before and after the taxable years involved in this controversy which should have been considered in determining whether the amounts outstanding in the bills payable account represented loans or equity invested capital during the taxable years 1953, 1954 and 1955.

CASTOLDI & BUTLER,
/s/ By FRANCIS J. BUTLER,
Counsel for Petitioner.

Certificate of Service Attached.

[Endorsed]: Filed July 8, 1959. Paul P. O'Brien,
Clerk.

[Title of Court of Appeals and Cause.]

DESIGNATION OF CONTENTS OF RECORD ON REVIEW

Comes now the Petitioner by and through its attorneys and designates the following portions of the record to be printed on review of the above entitled case from the Tax Court of the United States to the United States Court of Appeals for the Ninth Circuit:

1. Tax Court Petition.
2. Tax Court Answer.
3. Official Transcript of the Proceedings before the Tax Court.
4. Stipulation of Facts, without joint exhibits attached.
5. Deposition of Grace Lewis Phillips and John McPherson, dated November 8, 1957.
6. Supplemental stipulation of Facts without exhibits attached.
7. Findings of Fact and Opinion of Tax Court.
8. Order dated February 4, 1959 Amending Opinion.
9. Decision of the Tax Court.
10. Petition for Review with Proof of Service attached thereon.
11. Statement of Points Relied Upon.

12. Designation of Contents of Record on Review.

/s/ FRANCIS J. BUTLER,
Counsel for Petitioner.

Certificate of Service Attached.

[Endorsed]: Filed July 8, 1959. Paul P. O'Brien,
Clerk.

[Title of Court of Appeals and Cause.]

STIPULATION

Comes now the party, by and through its respective counsel, and stipulates that the exhibits entered in the above entitled proceeding, except the exhibit received in evidence which contains the deposition upon oral examination of Grace Lewis Phillips, and John McPherson, may be considered in their original form for the purpose of this appeal and that therefore the exhibits need not be produced in the printed record.

/s/ PAUL CASTOLDI,
/s/ FRANCIS J. BUTLER,
Counsel for Petitioner.

/s/ CHARLES K. RICE,
Assistant Attorney-General, Department of Justice,
Counsel for Respondent.

[Endorsed]: Filed July 18, 1959. Paul P. O'Brien, Clerk.

